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Interim Report

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Select Committee

on

ECONOMIC AND CULTURAL NATIONALISM

NATURAL RESOURCES, FOREIGN OWNERSHIP
AND ECONOMIC DEVELOPMENT

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* **On February 26, 1974 Mr. Newman and Mr. Handleman were sworn as Members of the Executive Council of the Province of Ontario. Since that time they have not participated in the deliberations of the Committee in the formulation of this report, and they accordingly neither subscribe to, nor dissent from the report.**

September, 1974

TO: The Honourable Allan E. Reuter,
Speaker of the Legislative Assembly of the Province of Ontario:

Sir:

We, the undersigned members of the Committee appointed by the Legislative Assembly of the Province of Ontario on December 17, 1971, to review the Report of the Interdepartmental Task Force on Foreign Investment and the current status of opinion and information on economic and cultural nationalism in Canada, have the honour to submit the attached Interim Report.

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NON-RENEWABLE NATURAL RESOURCES, FOREIGN OWNERSHIP AND ECONOMIC DEVELOPMENT

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NON-RENEWABLE NATURAL RESOURCES, FOREIGN OWNERSHIP AND ECONOMIC DEVELOPMENT

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17. A long-run goal of non-renewable natural resources policy should be to ensure that: 62

(i) At least 75 per cent of the equity of all new ventures in the non-renewable natural resources sector after the implementation of the Committee's recommendations be owned by Canadians; and

(ii) No single non-resident or related group of non-residents own more than 10 per cent of the equity of ventures in the non-renewable natural resources sector.

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18. The recommended Canadian ownership requirements in the non-renewable natural resources sector should be implemented in three stages over a 15 year period as follows: 63

    (i) After 5 years: At least 25% of the equity of non-renewable natural resources ventures must be held by Canadians;

    (ii) After 10 years: At least 50% of the equity must be held by Canadians;

    (iii) After 15 years: At least 75% of the equity must be held by Canadians and no more than 10% may be held by any one non-resident or related group.

19. Sanctions to be imposed on firms in violation of the Canadian ownership requirements should include the following: 65

    (i) Fines and/or imprisonment to be imposed on senior officers and directors who knowingly participate in the violation;

    (ii) Until the firm complies, the rate of growth in both the gross assets and gross revenue of the firm should be limited to 0%.

(ii) <u>Selective Government Equity Participation</u>

20. The Committee Recommends that:

    (i) New ventures in the non-renewable natural resources sector should be required to file with the Government of Ontario notice of proposed operations; 74

    *(ii) The Government should be empowered to take up to 50% of the equity in new ventures in the non-renewable natural resources sector;

    (iii) The Government should be required to notify the new venture whether and to what extent it wishes to take up equity within 15 days after filing of the notice. After the expiration of 15 days the Government would be deemed to have elected not to take up any equity.

* Messrs. Kennedy and Walker dissent from this recommendation. See p. 87

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Requests for Government equity participation initiated by firms in the natural resources sector should be screened by Ontario's Development Corporations and should be acted on only if

(i) the proposed venture is economically viable;

(ii) the proceeds of Government equity financing will be used in the development of the resource;

(iii) the required financing is not available from other Canadian sources;

(iv) control of the proposed venture will continue to be in the hands of Canadians; and

(v) Government equity participation is otherwise in the public interest.

21. As ventures in which it has an equity interest mature to the point that a secondary issue to the public is feasible, the Government should be empowered to offer its shares to the public at an appropriate price. The shares issued to the public should be constrained shares in that they cannot be sold to non-residents. 75

(iii) Royalty Payments in Shares

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1. The fair market value of the shares transferred to the Treasurer should be equal to the amount of cash royalties that would otherwise be exigible; the class and quantity of shares issued should be acceptable to the Treasurer.

2. The system should apply to both Canadian and foreign controlled firms.

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3. The maximum proportion of the outstanding voting shares issued to the Treasurer should not exceed 50 per cent at any time. Once the 50 per cent threshold is reached, royalty payments will be made in cash. If the corporation thereafter issues further shares, the corporation could again be required to pay royalties in shares until the 50 per cent limit is reached once more.

4. The Treasurer should be empowered to sell shares on the public markets. However, the sale of shares by the Treasurer should not operate so as to require the Company to issue more shares to the Treasurer; in no situation should the total number of shares issued to (but not necessarily held by) the Treasurer exceed 50% of the outstanding shares at any given point in time.

(iv) Mining Machinery and Engineering Consulting Services

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24. Policies should be developed to improve the performance of mining machinery and equipment firms in terms of exports, research and development and increasing Canadian value added. 84

NON-RENEWABLE NATURAL RESOURCES

NON-RENEWABLE NATURAL RESOURCES, FOREIGN OWNERSHIP AND ECONOMIC DEVELOPMENT

INTRODUCTION

Although there are a great many similarities between renewable natural resources (e.g. forest products, hydro-electric power) and non-renewable natural resources (e.g. mining, oil and gas), the Committee has concluded that there are fundamental distinctions which warrant analyzing these two aspects of the natural resources sector separately. Economic supplies of non-renewable resources are finite, whereas supplies of renewable resources can be exploited and replaced. This distinction counsels caution with respect to the rate of exploitation of non-renewable resources and suggests different approaches for the exploitation and replacement of renewable resources. Non-renewable resources which are exploited now cannot be exploited later, whereas renewable resources, such as hydro-electric power which are not currently exploited are forever lost.

Table I indicates the relative size of the manufacturing, the non-renewable and the renewable sectors of the Canadian economy in 1970. The renewable natural resources sector (defined as mining) is about one-third the size of the manufacturing sector in terms of assets employed,

TABLE I

ASSETS, SALES AND PROFITS

ATTRIBUTABLE TO FOREIGN AND CANADIAN CONTROLLED ENTERPRISE

SELECTED INDUSTRIES, 1970

	Foreign Controlled	Canadian Controlled	Other	Total
	(Amounts in millions)			
Manufacturing				
Assets	$27,572 59%	$18,663 39%	$1,052 2%	$47,287 100%
Sales	54%	42%	4%	100%
Profits	62%	37%	1%	100%
Non-Renewable Natural Resources (Mining)				
Assets	$10,422 68%	$4,596 31%	$185 1%	$15,573 100%
Sales	73%	25%	2%	100%
Profits	72%	29%	-1%	100%
Renewable Natural Resources (Agriculture, forest, fish)				
Assets	$201 13%	$811 54%	$493 33%	$1,505 100%
Sales	7%	56%	37%	100%
Profits	30%	50%	20%	100%

Source: CALURA, 1970, pp. 16, 28, 32.

whereas the renewable resources sector (defined as including agriculture, forestry and fishing) is only about one-thirtieth the size of manufacturing. Put another way, the non-renewable sector is about ten times the size of the renewable sector. Moreover, the phenomenon of foreign control is far more evident in mining than in the renewable resources sector. Whereas foreign controlled firms accounted for about 70% of the assets, sales and profits in non-renewable resources, foreign controlled firms accounted for only 13% of the assets, 7% of the sales and 30% of the profits in renewable resources.

Of the eight industrial classifications of non-financial industries used in the CALURA data, the renewable resources sector is among the lowest of all the classifications in terms of foreign participation and the non-renewable sector the highest.[1]

The differences in policy considerations applicable to the two aspects of the natural resources sector, has persuaded the Committee firstly, that non-renewable natural resources must be analyzed separately from renewable resources; secondly, that if policy initiatives are to be undertaken with respect to foreign ownership and control in the natural resources sector, such initiatives should be directed primarily to non-renewable resources; and thirdly, that major policy initiatives are required to enhance the Canadian presence in the non-renewable natural resources sector of the Canadian economy.

NON-RENEWABLE NATURAL RESOURCES

In the context of the Canadian economy a consideration of non-renewable natural resources involves primarily mining, oil and gas. Although Ontario is involved to some extent in the exploration for and production of oil and gas, the primary focus of concern in Ontario with respect to non-renewable resources is on mining. The analysis which follows concentrates on mining although much of the analysis is applicable to other aspects of the natural resources sector.

The Committee notes that there are in essence two separate, yet related policy issues involved in the consideration of foreign direct investment in the non-renewable resources sector. The first involves the balance between resource exploitation and manufacturing in the Canadian economy. The second involves the balance between foreign ownership and Canadian ownership within the resources sector. These two fundamental issues are related in that the degree of foreign ownership in the resources sector may to some extent influence the balance between resources and manufacturing in our industrial structure. The following sections consider each of these issues and seek to identify the interrelationships.

RESOURCES VS. MANUFACTURING

The Committee has found that historically a major element of the industrial development policies of Canada and Ontario has been the encouragement of non-renewable resource exploitation through a variety of incentives such as generous depletion allowances, tax holidays, subsidies and the like. Although the tax provisions in respect of income derived from resource exploitation have been substantially revised by the new federal tax legislation, a policy of highly favourable treatment of resource-based income remains intact contrary to the recommendations of the Carter Commission and the federal government's own policy statement in the White Paper. To be sure, these incentives to resource exploitation have been available to both Canadians and foreigners, generally on a non-discriminatory basis. Nevertheless, the realities of the world economy have been such that foreign owned firms have been in a unique position to take advantage of the favourable Canadian resource environment.

The Gray Report identified a number of factors which had the result of enabling foreign firms to respond to the opportunities of the favourable Canadian resource climate to the exclusion of Canadian owned firms.[2] There were two serious gaps in the Canadian environment which foreign firms could and Canadian firms could not overcome: Canadian financial markets could not readily supply the huge pools of capital required for resource developments; and foreign firms

had access to the large, secure markets which were required to render Canadian resource ventures economically attractive. In addition, foreign governments such as that of the U.S., and more recently Japan, have encouraged foreign resource development through tax incentives and low levels of barriers to imports of raw materials. Moreover, foreign firms, responding to a need to secure sources of supply of raw materials used in their large plants in the home country, have engaged in backward vertical integration involving Canadian resource ventures.

In summary, the particularly favourable Canadian resources environment created to a considerable extent by federal and provincial economic development policies has contributed in no small measure to the current balance between resources and manufacturing. We must recognize that the present balance, whether that balance is characterized as appropriate or inappropriate to Canada's needs, has been struck primarily as a result of Canadian economic policies and not primarily as a result of any sinister motivations on the part of foreign owned firms or governments.

To be sure, the fact is that a large proportion of the natural resources sector is foreign owned. It is tempting to conclude from that fact that the present balance between resources and manufacturing results from the high proportion of foreign ownership. However, here again we must recognize that the high level of foreign ownership has resulted from the mesh of Canadian resources policy and the

realities of the world environment. The Canadian policy of encouraging resource exploitation existed in an environment where Canadian capital markets were equipped neither to assemble the large individual pools of capital required for resource ventures nor to raise the large aggregate flows of capital required for resource developments; and where Canadian firms did not have access to secure markets for the output of resource ventures. If we wish to change the balance between resources and manufacturing we must develop a new set of substantive policies which recognize the realities of the Canadian and world economies.

Having examined the nature of the current balance between natural resources and manufacturing and having examined the process of how that balance was struck, we must now consider the consequences of that balance in order to determine whether the current balance is an appropriate one.

The current emphasis on resource exploitation has resulted in a relatively greater emphasis on capital as compared with labour. This has contributed to our unemployment problem. For example, while mineral production represented about 7 per cent of GNP in 1970, it accounted for only 1.4 per cent of the labour force.[3] Or the export of an additional $1 billion of energy resources to the U.S. would give us about $68 million in wages and salaries while

a compensating importation of $1 billion of manufactured goods would mean that we are importing between $200 million and $350 million in wages and salaries.[4] However, we must remember once again that this result is not attributable to the fact of foreign ownership per se, but to our own industrial policies for the employment results would be substantially the same if the resources sector were controlled by Canadians exclusively, other things being equal.

To the extent that resource ventures are financed from abroad, the resulting importation of funds puts upward pressure on the Canadian dollar relative to other currencies with the ultimate result that our manufactured goods become less attractive on the world market. To the extent that resource developments are financed on the Canadian capital markets, those funds and the underlying real resources are not available to develop other sectors of the economy such as manufacturing.

These considerations suggest that the current balance between resources and manufacturing as reflected in the Canadian economy and as reflected in current economic policies is weighted too heavily in favour of non-renewable natural resources. Therefore,

THE COMMITTEE RECOMMENDS THAT CANADIAN ECONOMIC POLICIES BE RE-ORIENTED SUCH THAT GREATER EMPHASIS BE GIVEN TO THE DEVELOPMENT OF THE MANUFACTURING SECTOR AND THAT THE NON-RENEWABLE RESOURCES SECTOR BE DE-EMPHASIZED.

In recommending that a new balance between manufacturing and non-renewable resources be drawn, the Committee is not

suggesting that resource development be discouraged. The Committee does, however, recommend a policy shift such that the current policy bias in favour of resources relative to manufacturing be removed. Accordingly,

THE POLICY SHIFT SHOULD INVOLVE NOT A DISCOURAGEMENT OF RESOURCE DEVELOPMENT BUT AN ENCOURAGEMENT OF MANUFACTURING AND PROCESSING IN CANADA.

FOREIGN VS. CANADIAN OWNERSHIP IN THE RESOURCES SECTOR

We have already seen that in 1969 foreign owned firms accounted for about 70% of the assets, sales and profits in the non-renewable resources sector. This represents the highest proportion of the eight industrial classifications used in the CALURA data. In the last section we discussed the process whereby this high degree of foreign ownership in the resources sector developed. It was noted that this process involved a convergence of a number of factors both internal and external to Canada:

internal factors:

- highly favourable policy environment to encourage resource exploitation;
- capital market gap - Canadian capital market unable to marshal the huge pools of funds required for resource ventures both for individual ventures and in the aggregate;
- marketing gap - Canadian firms unable to establish secure markets for output to render the venture attractive;

external factors:

- home countries encouraging the development of secure supplies of raw materials for inputs in domestic plants - tariff, tax policies;
- backward vertical integration by foreign firms to ensure secure sources of supplies of raw materials; foreign firms could guarantee markets for output.

Frequently in the debate concerning foreign ownership in the resources sector, the discussion proceeds on the basis of fixing on any one of the above factors as the cause of the high level of foreign ownership. The important point to note in any discussion of policy in this area is that our present situation results not from any one or another of the above factors, but from the convergence of all of the above factors. For example, if it were considered desirable to restrict future resource developments to Canadian firms, such a policy must recognize the capital market gap to the extent it exists and the marketing gap. If it is desirable to encourage processing in Canada, such a policy must come to grips with the propensity of foreign governments to treat imports of processed goods less favourably than unprocessed goods.

The Committee notes that the time period during which the development of Canadian resources took place and during which the high degree of foreign direct participation in this sector developed, involved a general situation where world supplies were abundant relative to demand. The Committee senses the development of the opposite situation where world supplies of resources are tighter. In such a situation Canada may well be in a position, for example:

(i) to influence other countries' tariff, tax and other policies;

(ii) Canadian owned resource firms may now be in a better position to develop secure markets for their output.

What are the effects of a high degree of foreign participation in a sector which is so important to the Canadian economy? The Gray Report has listed the costs and the benefits of foreign direct investment in the resources sector.[5] The costs and benefits listed in the Gray Report are largely economic in nature. The Committee is of the view that it is not possible to make a conclusive determination of the net economic benefits of foreign direct investment in non-renewable resources because many of the costs and benefits are qualitative and not readily susceptible to quantification. A balancing of the costs and benefits is perforce a judgemental matter. In any event, such a determination is past-oriented; past costs and benefits cannot be altered. Nevertheless, the Committee has concluded that, on balance, foreign capital in the resources sector has made a substantial contribution to the development of Canada and that foreign capital will continue to play an important role in the future.

Our concern, however, is not so much with the past but with the future. Throughout the Committee's hearings and its efforts to gauge public opinion and attitudes with respect to foreign ownership and control, the Committee has sensed a general mood of disappointment and frustration among Canadians with the fact that Canada's and Ontario's rich endowment of natural resources is controlled to a large degree by non-Canadian firms. Even if one concludes, as the

the Committee has concluded, that on the basis of a balancing of the economic costs and benefits of foreign investment in natural resources has been and will continue to be of benefit to Canada, this public mood of disappointment and frustration is an important factor to which public policy in relation of natural resources must respond. Moreover, the Committee is convinced that the net economic benefits to Canada of investment in the non-renewable natural resources sector can be enhanced by the development of a greater degree of Canadian ownership and control in that sector. The Committee therefore concludes that there is a need for a strong and visible Canadian presence in the various aspects of the natural resources sector.

THE COMMITTEE RECOMMENDS THAT ONE IMPORTANT GOAL OF BOTH PROVINCIAL AND FEDERAL RESOURCES POLICIES BE THE ACHIEVEMENT OF A STRONG AND VISIBLE CANADIAN CONTROLLED PRESENCE IN THE NON-RENEWABLE NATURAL RESOURCES SECTOR.*

We shall consider later in this Report the specific policy tools available to implement this recommended goal. At this stage we shall consider the general approach that resources policies should take in this respect. The recommended policy goal of achieving a strong and visible Canadian presence may be achieved in a variety of ways. One policy position would be that foreign direct investment in resources

*For comment by Messrs. Deans, Martel and Smith, see p. 86.

be excluded entirely by mandated Canadian participation in each resource venture. Another approach is to enhance the ability of Canadian firms to develop natural resources. Or resources policies could reflect both of these approaches.

The complete exclusion of foreign capital is a negative approach which in our view should be avoided if possible. It is in the final analysis an approach which assumes that Canadians are not capable of ever competing with foreign investors. In substance, it assumes that Canadian policy is incapable of creating an environment which is conducive to a strong Canadian presence in the resources sector. We are convinced that neither of these assumptions is correct. In fact, we are convinced that policy techniques are available to create an environment in which the competitive instincts and abilities of Canadians can be directed towards our recommended goal. Such a positive environment will result in the achievement of that goal without the deleterious effects which a negative, restrictive environment implies.

Even though the Committee has concluded that foreign direct investment has made a substantial contribution, the Committee is nevertheless convinced that Canada can achieve a more favourable balance in terms of the traditional cost-benefit analysis. We are persuaded that with the appropriate policy tools Ontario and Canada can increase the benefits and reduce the costs of foreign direct investment in the resources sector.

It has been observed that the Canadian resource operations of foreign firms tend to be part of a vertically integrated firm. This has led to the observation that Canadian operations tend to be truncated because much of the processing and fabrication takes place abroad. However, to make that observation does not mean that a causal relationship has been identified. In other words, it does not answer the question whether the Canadian operations are truncated <u>because</u> they are foreign controlled. Put another way, if the resource sector had developed under exclusive Canadian control would it have been less truncated? These are in substance indeterminate questions. It is probably not useful to belabour them unduly. If we want more processing in Canada, a more fruitful approach would appear to be the establishment of explicit requirements to that effect rather than to engage in the questionable kind of reasoning to the effect that more Canadian ownership in the resources sector will result in a greater degree of processing in Canada. We will consider policy tools directed towards more processing in Canada in a later section.

The fact that foreign controlled resource operations are part of an integrated industrial system can render it very difficult for independent Canadian firms to establish competing operations. The output of the system's Canadian operations can be transferred abroad via transactions that are not at arm's length. This could permit the

integrated system to discourage competition by keeping those activities unprofitable. Representations were made to the Committee that that in fact occurs. However, when pressed, those making this argument could not substantiate it. In any event, to the extent that pricing policies may be manipulated in this way, they should be dealt with by the combines legislation. Pricing policies have tax implications as well. Even if the tax rules and procedures are successful in neutralizing the tax effects of the manipulation of transfer pricing, they are unlikely to have any effect on the anticompetitive aspects. As a practical matter the current screening process established by the Foreign Investment Review Act can serve a supplementary and supportive role in detecting and neutralizing the anti-competitive effects of the manipulation of transfer prices.

POTENTIAL POLICY TECHNIQUES

I. REMOVAL OF INCENTIVES

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I. REMOVAL OF INCENTIVES

The Committee concluded above that a new balance between manufacturing and natural resources be drawn by, among other things, the reduction or elimination of the substantial tax incentives that have been granted to resource exploitation by our tax legislation. The Appendix briefly sets out the current tax position of the natural resources sector and notes the changes proposed in the recent federal and provincial budgets. We emphasized that the process of drawing a new balance should involve more encouragement of manufacturing, processing and fabrication in Canada relative to primary extraction rather than merely removal of the incentives now granted to resource exploitation.

To the extent that special incentives to the resources sector are retained, there is a strong argument to be made that tax incentives be restricted to corporations controlled by Canadians. We are advised that the operation of the foreign tax credit provisions extant in the tax systems of foreign countries, particularly the United States, is such that if the Canadian tax incentives were removed, the resulting increase in Canadian tax payable by foreign controlled corporations could be offset, at least to some extent, against their tax liabilities in their home jurisdictions. Put another way, the benefit to the foreign controlled

corporation of the reduced Canadian tax resulting from the special tax incentives are offset, at least in part, by higher tax liabilities in the home country.

Due to time and manpower limitations, the Committee has not undertaken an in depth study of the complexities involved in a consideration of the foreign tax credit mechanisms of foreign jurisdictions and how they relate to Canada's tax system. It is the view of the Committee that such a study is best left to the experts and those involved in the administration of our tax system. Since the efficiency of the tax system in this connection has national and international implications, the Committee would suggest that this study be undertaken by the federal authorities. The study has important implications in terms of the efficiency of our incentives to the resources sector. Accordingly,

THE COMMITTEE RECOMMENDS THAT A STUDY BE UNDERTAKEN BY THE FEDERAL GOVERNMENT TO DETERMINE TO WHAT EXTENT THE OPERATION OF FOREIGN TAX SYSTEMS NEUTRALIZE THE EFFECT OF CANADIAN INCENTIVES TO THE NATURAL RESOURCES SECTOR.

We have noted that about 70 percent of the assets, sales and profits in the natural resources sector is attributable to foreign controlled corporations. Moreover, many of those corporations are part of a vertically integrated system. To the extent that the foreign tax credit provisions

operate as the Committee has been advised, the net effect of the Canadian tax incentives granted to those corporations is to provide additional revenues to foreign public treasuries at the expense of the Canadian federal and provincial treasuries without any real benefit accruing to the Canadian economy.

Should the recommended study confirm this argument, the Committee would recommend that the incentives to encourage resource development which are retained be restricted to Canadians. To the extent that this is done, the ability of Canadian controlled firms to engage in resources development will be enhanced.

To the extent that the incentives for non-renewable resource exploitation are removed, the Canadian resources environment will be rendered relatively less favourable for Canadian and foreign firms alike. However, this of itself does nothing to enhance Canadians' ability to participate in the development of our resources. In the following sections, we shall consider specific policy techniques designed to accomplish this goal.

POTENTIAL POLICY TECHNIQUES

II. REMOVAL OF INTERNAL AND EXTERNAL IMPEDIMENTS

II. REMOVAL OF INTERNAL AND EXTERNAL IMPEDIMENTS

We have noted that in the past the unique ability of foreign firms to take advantage of Canadian resource opportunities stems in part from several internal deficiencies in the Canadian economic environment and in part from factors external to Canada. We shall consider each of these in turn.

(i) Internal Factors - Capital Market Gap

In the past, the Canadian capital market has displayed an inability to marshal the large pools of capital required for the financing both of individual resource ventures and of aggregate resource development over time. This inability has been referred to as the capital market "gap" in relation to natural resources. The Canadian capital market generally has been analyzed in a separate report published by the Committee.[6] We shall consider in this section how this particular capital market gap in relation to resources might be remedied.

It is appropriate at this point to recall our recommendation that a new balance between resources and manufacturing be drawn by, among other things, removing the policy bias in favour of resources vis à vis manufacturing. We have recommended that this new balance be achieved, not so much by means of actively discouraging resource development but more by means of encouraging manufacturing, processing and fabrication in Canada.

It has been urged upon the Committee that major resource developments such as the MacKenzie Valley pipeline are not in the best interest of Canada for a variety of reasons, including the major impacts such developments would have on the capital markets and the balance of payments. As a result, it was argued before the Committee that resource ventures of this nature be actively discouraged or banned. An exhaustive evaluation of the desirability of specific major natural resource developments is not only outside the terms of reference of the Committee but also beyond the resources which the Committee had at its disposal. Nevertheless, the Committee is of the view that the policy emphasis in the broad spectrum of the Canadian economic environment should be a positive rather than a negative one in the sense that desired activities be encouraged rather than undesired activities actively discouraged or banned outright. It is the view of the Committee that our economic system operates most effectively in a positive rather than a negative policy environment.

If it be determined as a matter of public policy to encourage manufacturing relative to resource developments as the Committee has recommended, this should be done by altering the economic environment of resource ventures through such measures as changes in resource taxation and requiring more processing and fabricating in Canada. In this way the capital market will be in a position to perform its function of allocating investment funds efficiently

within the total economic environment to ensure that in the aggregate the maximum economic activity will take place.

The capital market gap has been identified as an inability on the part of the Canadian capital market in the past to supply the large pools of capital required to underwrite individual large resource ventures and to finance aggregate Canadian resource development over time. In its Report of the Capital Markets, the Committee noted that in the aggregate the level of domestically generated savings approached or exceeded the volume of domestic investment in recent years. However, the Committee also noted that self-sufficiency in aggregate terms does not mean that on a sectoral or individual project level the required capital will be forthcoming from domestic sources. The Committee has concluded that a gap continues to exist in the Canadian capital market in supplying the pools of capital required to finance resource ventures. However, the extent of this gap may not be as great as it has been in the past. Nevertheless, the Committee recognizes that Canada is on the threshold of a period in which huge resource ventures related particularly to oil and gas will make great demands upon Canadian capital markets and in which this gap in the capital market will become increasingly evident. As Ontario is the cornerstone of the Canadian capital market, it behooves this Province to develop policy responses.

In remedying this capital market gap in relation to natural resources development the Committee sees an important and continuing role for foreign capital. Nevertheless, the Committee is of the view that this role should be a different one than in the past. We noted in the Report on the Capital Markets that since the 1920's foreign investment has taken the form of direct as opposed to portfolio investment, predominantly from the United States. The Committee has concluded that in the future foreign investment, particularly in the non-renewable resources sector, should take the form of portfolio rather than direct investment.

The Committee bases this conclusion on several factors. First, the promotion and encouragement of foreign portfolio rather than direct investment will promote the policy goal recommended by the Committee of achieving a strong and visible Canadian controlled presence in the non-renewable natural resources sector.

Second, the fact that more controlling equity positions in resource ventures will be located in Canada will mean that the residual benefits of ownership and control will accrue to the benefit of the Canadian shareholders and Canada generally. This is particularly important in a world environment in which there appears to be developing prolonged periods of shortages of natural resources. The analogy with the concept of leverage used in the field of corporation

finance is apposite: In the present situation with about 70% of the assets, sales and profits of the non-renewable resources sector attributable to foreign direct investment, it would appear that Canada as a nation is underleveraged in this sector. The promotion of foreign portfolio investment relative to direct investment would relieve the imbalance.

Third, a further sort of leverage to be achieved is a public policy leverage. To the extent positions of control in the non-renewable natural resources sector will be situated in Canada, this sector will be more amenable to Canadian public policy regulation and less amenable to regulation, direct or indirect, by foreign governments. Moreover, Canadian control will mean that decisions about Canadian resources are made in Canada. The Committee is convinced that decisions made in Canada are more likely to be in Canada's interest than decisions effectively made abroad by foreign controlling interests. In view of the above considerations,

THE COMMITTEE RECOMMENDS THAT CANADIAN RESOURCES POLICIES, PARTICULARLY IN RESPECT OF NON-RENEWABLE NATURAL RESOURCES, PROMOTE FOREIGN PORTFOLIO RATHER THAN DIRECT INVESTMENT IN CANADIAN VENTURES.

The Committee is concerned that effective control of resource ventures be retained in Canada. This means that

foreign firms could participate by way of debt or equity, provided that the combination of foreign debt and equity participation does not carry with it effective control.

The Committee is convinced that the world economic environment, particularly in relation to natural resources, is now such that Canada can, as a nation, insist that foreign inflows of funds be primarily in the form of portfolio rather than direct investment. First, the increasing concern about relative scarcity of non-renewable natural resources on the world level enhances Canada's position in this regard. Second, we have noted that in aggregate terms the potential level of Canadian savings appears to be sufficient to satisfy aggregate desired investment. The problem is to channel Canadian savings in support of Canadian ownership and control. The Committee is of the view that an effective, well articulated public policy in this regard will provide the impetus for the Canadian capital markets to do just that.

Third, the pattern of world sources of funds has been shifting in recent years. Although the United States is still a very important factor, its importance as a source of funds is declining. The European capital markets, Japan and more recently the Arab nations are becoming increasingly important sources of funds. Along with this geographical shift in the sources of funds, the Committee understands that European, Japanese and Arab investors are relatively less interested in direct investments than are

the Americans. This greater interest of Europeans, Japanese and Arab investors in portfolio investment matches the Committee's recommendation to promote foreign portfolio investment and to discourage direct investment.

A geographical dispersion of the sources of funds upon which Canada draws will render an added advantage to Canada. Currently, a great proportion of foreign investment in Canada is sourced in the U.S. For a variety of reasons this is of concern to many Canadians. With Canada drawing on a greater variety of world sources of funds in the future, this concentration of investment will to some degree be ameliorated.

The Committee is not convinced that the Canadian capital market has sufficiently explored sources of funds alternative to those in the United States. The Committee visualizes a number of reasons for this, primarily the close proximity of the U.S. capital market in terms of distance, common language, institutions and similarity of modes of operation. Nevertheless, the Committee is convinced that much can be done to make greater use of alternative world sources of funds, especially in view of the very large resource ventures looming on the horizon. On the basis of these considerations,

THE COMMITTEE RECOMMENDS THAT GREATER ATTENTION BE GIVEN TO DEVELOPING AND TO DRAWING ON FOREIGN SOURCES OF CAPITAL OTHER THAN THE UNITED STATES.

In implementing this recommendation, the Committee visualizes an important role not only for the institutions of the Canadian capital market, but also for the Government of Ontario. In the Report on the Capital Markets, the Committee recommended the establishment of a body in the Ministry of Industry and Tourism, among other things, to monitor the capital market in Ontario. One important function of this body should be to assist the Ontario institutions in exploring and developing these alternative sources of capital. A government involvement in this connection may be invaluable in dealing with such sources of funds as the Arab nations and Japan where government involvement is extensive and whose governments consider important other governments' involvement in negotiations with them.

Thus far we have considered the future role of foreign investment in meeting the capital market gap in relation to the natural resources sector. We have recommended that this role be limited to the extent practicable to portfolio investment. At this stage of the analysis, one must consider how in practical terms this is to be accomplished and how to improve the capital market's ability or its willingness to marshal the required capital in support of Canadian equity ownership.

The screening process established by the long considered and recently enacted Foreign Investment Review Act will of itself, to some degree at least, serve to limit

direct investment by non-residents. This is in effect accomplished in a number of ways. The mere fact of non-residents having to submit their proposed takeovers or new ventures to the screening agency which is in effect empowered to bargain for increased Canadian ownership will have some effect in that direction. Nevertheless, the screening process does not apply to expansions of existing foreign controlled firms in related industries. As a large proportion of the natural resources sector is foreign controlled, this is a major gap in the screening process. It can be expected that a considerable part of the future development of the Canadian resources sector will come from the expansion within the resources sector of foreign controlled firms. This is an important gap in the screening process. The Foreign Investment Review Act will be more fully analyzed in a subsequent Report of the Committee.

We shall consider in detail later in this Report the various techniques which could be used to limit foreign investment to portfolio investment and to support Canadian ownership and control in the non-renewable natural resources sector.

(ii) Internal Factors - Marketing Gap

The Committee noted earlier that relative to foreign controlled resource firms which tend to be part of

an integrated system based abroad, Canadian firms encountered difficulty in establishing secure markets for their output necessary to render the venture attractive and necessary to secure the financing from the capital market.

It is clear that the Canadian economy is generally not of sufficient size to absorb the large output required from resource ventures of a size sufficient to achieve economies of scale. The key to the success of Canadian resource ventures is the development of stable and secure foreign markets for their output. For much of Canada's past, the world situation in terms of the supply and demand for raw materials, particularly minerals, was that there was an excess supply. In this kind of environment, firms which were part of foreign based integrated systems had a distinct advantage over Canadian firms in access to secure foreign markets. It was this advantage of foreign controlled firms, together with the inability or unwillingness of the Canadian capital market to marshal funds in support of Canadian controlled firms, which set in motion and perpetuated the process that resulted in the very high degree of foreign controlled participation in the natural resources sector.

This process was a cumulative and self-perpetuating one. The relative inability of Canadian firms to develop secure foreign markets inevitably led to a reluctance on the part of Canadian sources of capital to

commit the very large funds required for any given resource venture. The economics of the mining sector are such that plants of very large size are required to enjoy the economies of scale and to be competitive internationally. In turn, the difficulty which Canadian firms had in obtaining financing of the required scale exacerbated their efforts to secure foreign markets since potential purchasers wished to be assured of supply once purchase commitments were made.

A contributing factor to this process was perhaps that the foreign based integrated systems chose, for a variety of reasons, to take the bulk of their profits abroad at the marketing end of this system. It has been argued before the Committee that the major motivation for this was that the integrated system wished to discourage entry by competitors. The integrated system was in a position to control its markets of finished goods to a considerable degree through such means as advertising, product differentiation and the like whereas the system was not in a strong position to exercise any appreciable control over markets for raw materials or semi-processed goods. Accordingly, the integrated system sought to discourage competition at the stage of the system most accessible to competitors - the extractive stage - by keeping those activities unprofitable.

It is to be noted that this process which has resulted in a large proportion of Canadian resource activity being under foreign control proceeded in a period of rela-

tively abundant supply of resources on a world level. The Committee notes that currently there appears to be a general world shortage of supplies of raw materials. If this situation continues in the future, the ability of Canada as a nation to establish secure markets for its output will be enhanced. However, even if this is so, the Committee is convinced that the relative inability of Canadian controlled firms to establish secure markets will not be improved without policy initiatives. Therefore,

THE COMMITTEE RECOMMENDS THAT AN IMPORTANT GOAL OF BOTH PROVINCIAL AND FEDERAL RESOURCES POLICIES BE THE IMPROVEMENT OF CANADIAN CONTROLLED FIRMS' ABILITY VIS À VIS FOREIGN CONTROLLED FIRMS TO DEVELOP SECURE MARKETS FOR THEIR OUTPUT.

In this connection, the Committee would suggest initiatives on three broad fronts. First, the screening process established under the Foreign Investment Review Act could play an important role. This will be considered in detail in a subsequent Report of the Committee. In reviewing direct investments proposed by foreign controlled firms, consideration should be given to developing relationships between the foreign investor and Canadian controlled firms such that the latter would ensure supplies of resources and the former would bring its access to foreign markets into the relationship.

THE COMMITTEE RECOMMENDS THAT THE FOREIGN INVESTMENT REVIEW AGENCY IN ITS REVIEW OF DIRECT INVESTMENTS IN THE NON-RENEWABLE NATURAL RESOURCES SECTOR CONSIDER, AS AN ALTERNATIVE TO THE DIRECT INVESTMENT, THE DEVELOPMENT OF RELATIONSHIPS BETWEEN THE FOREIGN INVESTOR AND CANADIAN CONTROLLED FIRMS SUCH THAT THE FORMER WOULD CONTRIBUTE ITS ACCESS TO FOREIGN MARKETS AND THE LATTER WOULD ENSURE SUPPLIES OF RESOURCES.

Second, the Committee sees a more active role for both federal and provincial governments in developing access for Canadian controlled firms to secure foreign markets. Both levels of government, in conjunction with Canadian firms, should initiate discussions with foreign governments and firms, and should become actively and aggressively involved on a continuing basis in developing foreign markets for Canadian resource firms. Although government activities in this connection should not be undertaken solely for the benefit of Canadian controlled firms, the Committee suggests that such activities favour Canadian controlled firms in recognition of the special difficulties which such firms have compared with foreign controlled firms in establishing secure foreign markets.

Government involvement in establishing foreign markets would ensure that Canada's interest in enhancing the degree of processing in Canada is promoted. For a variety of reasons, resource firms operating in Canada

individually may not be inclined or be in the position to bargain with foreign governments or firms for more Canadian processing. Government involvement would maximize the likelihood that bargaining efforts along these lines are made effectively and that those efforts are successful.

Moreover, many foreign governments are actively engaged in the search for secure sources of supplies of raw materials; the government of Japan is a notable example in this regard. The Committee understands that such governments prefer to involve the governments of the potential sources of supply in negotiations leading to long term purchase commitments. An active involvement on the part of our governments would on the one hand cater to that preference and on the other hand ensure that the Canadian public interest is adequately represented in negotiations with foreign governments.

A third initiative to improve Canadian controlled firms' access to markets abroad is to encourage the forward integration of Canadian controlled resource firms. The Committee has noted that one of the major features in the development of the present structure of the natural resources sector has been the presence of foreign controlled, vertically integrated systems in this sector. Forward integration of Canadian resource firms towards ultimate markets for their output will have the effect in the long term of ensuring greater access to markets abroad.

Developments along these lines parallel in many respects the backward integration undertaken in the past by foreign firms. Foreign firms engaged in backward integration in order to develop secure sources of supplies of raw materials. Canadian firms would integrate forward to develop assured and easier access to consumer markets. And just as foreign firms in the past used their positions in foreign markets as a base for backward integration towards the sources of raw materials, Canadian controlled firms are now able to use their position in terms of access to raw materials as a base to integrate towards consumer markets. In this connection, it is to be noted that the backward integration of foreign firms proceeded in a period of relatively abundant supplies of resources and that the access of foreign firms to markets for finished goods was the strength upon which the forward integration process was based. The current world position of relatively tight supplies of resources would appear to constitute a position of strength upon which Canadian firms could base a process of integration towards foreign consumer markets.

(iii) External Factors - Foreign Tariff and Tax Policies

The combination of tariff and tax policies of foreign countries tends to encourage the development of secure sources of supply of raw materials in Canada and their exportation from Canada in relatively unprocessed

form. Table II illustrates, by way of specific example in connection with the U.S. tariff on imports of various forms of nickel, the tendency of tariff systems to subject imports of raw materials to higher levels of duty as the degree of processing and fabrication increases. Indeed, this tendency is imbedded in tariff structures throughout the world including that of Canada.

The Committee identified above the employment effects of the resources sector as compared with the manufacturing sector.[7] We noted that the employment content of activity in the resources sector was substantially less than that in the manufacturing sector. Moreover, these foreign tax and tariff policies enhance the ability of foreign firms to exploit Canada's resources relative to Canadian firms.

As noted in the discussion of the marketing gap, foreign based integrated firms have established access to their home markets. Integrated systems tend to derive the bulk of their income from the processing and marketing or "downstream" end of their operations. Due to the home country's tariff structure which discourage importation of processed goods, the downstream operations are located in the home country. The relatively large downstream profits available to the integrated systems in the home countries enable them to accept the relatively large and risky expenditures associated with resource development and exploitation in Canada.

TABLE II

UNITED STATES TARIFF RATES ON CANADIAN EXPORTS OF NICKEL (1969)

Form of the Nickel	Short Tons	Percentage	U.S. Tariff
In matte	69		free
In oxide sinter	19,491	18.3	free
Refined metal (normally raw cathode nickel)	86,768	81.6	flakes - 8 cents per lb.*
			anodes - 8 cents per ad valorem*
			angles, shapes, sections - 14% ad valorem
Finished metal		Small	bars, plates, sheets, strips - 19% ad valorem
Total	106,328	100.0	

* This tariff was suspended in 1969 during nickel shortage.

Source: Ontario, Select Committee on Economic and Cultural Nationalism, Foreign Ownership and The Mining Industry, October, 1973, p. 33.

On the other hand, Canadian resource firms do not have the same access to foreign markets for processed goods. This makes it difficult for Canadian firms to establish the downstream processing operations which in the case of the foreign based integrated systems are the source of the income and strength that enable them to accept the large and risky expenditures involved in resource development. Even if Canadian firms could establish secure foreign markets, the present tariff structures of foreign countries would often require that the processing facilities be established in the country where the market is located. This is so because foreign duties on unprocessed imports are generally nil or negligible whereas duties on processed imports are significant.

The Committee has concluded that it is in Canada's interest as a major supplier of raw materials to endeavour to have the bias in favour of unprocessed raw material imports removed from tariff structures. Accordingly,

THE COMMITTEE RECOMMENDS THAT A MAJOR GOAL OF CANADA IN FUTURE TARIFF NEGOTIATIONS BE THE REMOVAL OF THE CURRENT BIAS OF WORLD TARIFF STRUCTURES THAT GENERALLY FAVOUR IMPORTS OF UNPROCESSED GOODS.

In view of our earlier recommendation that public policy enhance the ability of Canadian controlled firms to establish secure foreign markets, it is important to recognize that present tariff policies would tend to have

the effect of Canadian firms locating processing and manufacturing facilities abroad. If one of the goals of economic policy is to encourage processing and manufacturing in Canada, it is necessary to supplement the recommended policy initiatives with regard to improving Canadian controlled firms' ability to establish foreign markets with policy efforts designed to ensure that processing facilities are located in Canada to the maximum extent practicable.

The major responsibility in Canada's endeavour to remove the tariff bias in favour of unprocessed goods rests with the federal government for it involves bilateral or multilateral tariff negotiations with our trading partners. The current GATT negotiations, now in the preliminary stages, present an ideal opportunity to make some progress in this connection. Our bargaining position relative to the removal of this bias would appear to be enhanced in the present world environment involving a general world shortage of raw materials. In this connection, it is to be noted that the Canadian tariff also reflects a bias in favour of unprocessed imports and Canada will have to show a willingness to remove this bias in its own tariff structure.

Although the responsibility with respect to tariff negotiations is primarily federal, provincial governments have an important role in identifying desired

changes in tariff policies, in assisting in the development of appropriate bargaining positions and in ensuring that provincial interests are adequately represented.

(iv) External Factors - Vertical Integration

One of the major factors which has contributed to the large degree of foreign control in the non-renewable natural resources sector has been the backward vertical integration of foreign controlled resource-based industrial systems. There have been a number of motivations for this process including the desire of those systems to develop secure sources of raw materials. We have noted that the ability of Canadian firms along these lines has been constrained by a combination of considerations, including the capital market and the marketing gaps. Indeed, to the extent those gaps and deficiencies are remedied along the lines recommended by the Committee, the ability of Canadian firms to develop into integrated systems will be improved. Although the Committee is convinced that the recommended policy initiatives will create the kind of environment necessary for the development of a strong and viable Canadian controlled presence in this sector, the Committee is of the view that specific policies are necessary to encourage the development of Canadian based firms which are vertically integrated. Accordingly,

THE COMMITTEE RECOMMENDS THAT FEDERAL AND PROVINCIAL RESOURCES POLICIES ENCOURAGE THE DEVELOPMENT OF CANADIAN CONTROLLED VERTICALLY INTEGRATED RESOURCE FIRMS.

This recommendation can be pursued in several ways, including processing in Canada requirements and direct government participation in resource firms. Specific techniques along these lines will be considered in detail below.

The Committee notes developments in this connection such as the acquisition by the Canada Development Corporation of a controlling interest in Texas Gulf. Whether or not CDC control will have a significant impact on the operations of Texas Gulf specifically and on the Canadian natural resources generally remains to be seen.

The Committee made reference earlier to the argument sometimes made that the presence of foreign based integrated systems in the Canadian industry have had an anti-competitive effect in that the system can manipulate transfer prices in such a way to keep its Canadian operations unprofitable and thereby make it unattractive for independent Canadian firms to compete.[8] The Committee is not convinced that this is so because of the very large and risky expenditures necessary to develop a resource venture and because U.S. tax law encourages the accumulation of profits in the extractive stages in order to earn maximum depletion allowances.

The Committee found no evidence to support the argument that transfer prices were manipulated in an anti-competitive way in the natural resources industry. However, it should be noted that the Committee's researchers had no investigative powers and that the research was conducted in a qualitative, interview-oriented manner.

To the extent that the capacity exists for integrated systems to manipulate transfer prices in an anti-competitive manner, it is necessary for public authorities to remain vigilant. Indeed, the machinery presently exists to detect and to counter such anticompetitive manipulations. Our anti-combines policies, tax rules and procedures and the expanded screening process recommended elsewhere by the Committee would appear to be adequate in this connection.

POTENTIAL POLICY TECHNIQUES

III. EXISTING REGULATORY APPROACHES

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(i) Processing in Canada

On the basis of the Committee's hearings, investigations and commissioned studies, the Committee concluded that the failure of the natural resources industry to engage in more processing and fabrication in Canada is related to the high degree of foreign control in the industry. The study of the mining industry commissioned by the Committee concluded that Canadian controlled firms engaged in more processing and fabrication in Canada than did foreign controlled firms. However, great care must be taken in drawing policy inferences from that conclusion.

It is one thing to identify the direction of the relationship between control and processing in Canada. It is quite another thing to identify the exact extent of this relationship. It may well be true that a greater degree of Canadian control in the natural resources sector will mean a greater proportion of the output being processed and fabricated in Canada. However, a policy of precluding foreign control may mean less total activity in this sector. In order to assess the desirability of a policy of excluding foreign control as compared with alternative policies, it would be necessary to establish convincingly that Canadian control in itself would yield substantially more processing in Canada. This the Committee has not been able to do on the

basis of the available information. In fact, the Committee suspects that the benefits in terms of more processing in Canada to be achieved from a policy of restricting control to Canadians would not be sufficient to offset the costs involved in precluding foreign investment.

It may be that a policy of encouraging Canadian control and limiting foreign control may be appropriate. Nevertheless, the Committee is convinced that a policy of totally excluding foreign control cannot be supported on the basis that such a policy by itself will yield substantially more processing in Canada. Indeed, the Committee firmly believes that the goal of achieving more processing and fabricating in Canada is most efficiently promoted by explicit policies directed towards that goal and directed at all firms in the industry, whether Canadian or foreign controlled.

The Committee recognizes that there are currently in place several policy techniques impinging on the natural resources environment in Ontario designed to encourage the further processing of raw materials in Canada. The Committee supports the goal of these techniques and accordingly,

THE COMMITTEE RECOMMENDS THAT THE GOAL OF ACHIEVING MORE PROCESSING AND FABRICATION OF RAW MATERIALS IN CANADA BE AN IMPORTANT GOAL OF NATURAL RESOURCES POLICIES.

The Committee notes that the present policy techniques that require or encourage processing in Canada apply to all firms whether Canadian or foreign controlled. In accordance with its conviction that the goal of encouraging processing in Canada is most efficiently promoted by policy techniques directed to all firms in the industry irrespective of ownership,

THE COMMITTEE RECOMMENDS THAT POLICY TECHNIQUES DESIGNED TO PROMOTE THE GOAL OF ENCOURAGING PROCESSING AND FABRICATION IN CANADA BE DIRECTED TO ALL FIRMS IN THE INDUSTRY IRRESPECTIVE OF OWNERSHIP.

Concern that raw materials are not sufficiently processed in Canada has been expressed for a long time. The Gordon Commission suggested ways to promote processing minerals in Canada.[9] In 1969 the Ontario Government enacted legislation designed to encourage the processing of ores to the metal stage. The Mining Act permits the Lieutenant Governor in Council to cancel mining leases if mining operations do not meet the processing-in-Canada requirements. There are provisions which enable the Lieutenant Governor in Council to exempt any lands from the processing requirements.[10] The Mining Tax Act permits an annual deduction for mining tax purposes of 10% of the costs of development provided that the ore is beneficiated at least to the smelter stage in Canada.[11] Prior to the re-enactment of the Mining Tax Act in 1972, there were

provisions which permitted selective exemptions from the processing in Canada requirements.[12] With the 1972 revision of the Act, this provision was dropped.

The Committee understands that the exempting powers under the Mining Act and formerly under the Mining Tax Act have been liberally used. While it recognizes that exemptions may be necessary in particular circumstances, the Committee would suggest that exemptions be granted only in situations where they are clearly required. In any event, exemptions should be reviewed periodically and removed in appropriate circumstances. Decisions to grant or refuse exemptions and the reasons for the decision, whether pursuant to an original application or under the proposed periodic review, should be made public in order that the direction of public policy is clearly before the industry and the public. Accordingly,

THE COMMITTEE RECOMMENDS THAT DECISIONS TO GRANT EXEMPTIONS FROM THE PROCESSING-IN-CANADA REQUIREMENTS UNDER THE MINING ACT BE REVIEWED PERIODICALLY AND THAT DECISIONS TO GRANT OR REFUSE EXEMPTIONS AND THE REASONS THEREFOR BE MADE PUBLIC.

In connection with the reduction of mining taxes in return for a greater degree of processing in Canada,

THE COMMITTEE RECOMMENDS THAT CONSIDERATION BE GIVEN TO A SYSTEM OF "EARNING" REDUCTIONS IN TAX ACCORDING TO A SLIDING SCALE DEPENDING UPON THE PROPORTION OF THE OUTPUT FABRICATED IN CANADA AND UPON THE STAGE TO WHICH OUTPUT IS PROCESSED.

It should be noted that the processing in Canada need not be done by the same firm; it is sufficient that the resources be processed and fabricated in Canada by any firm.

A system of earning tax reductions along these lines could be incorporated in both the provincial and federal tax structures. A sliding scale system of this sort would result in continuing pressure on resource based firms to increase the proportion of output processed in Canada and to advance the stage to which output is processed in Canada.

Federally, there are no legislative provisions in force designed to encourage processing in Canada. However, early this year, the government introduced Bill C-4, An Act to amend the Export and Import Permits Act, which would permit the Governor in Council to control the export of goods to ensure that actions taken to promote the further processing in Canada of natural resources are not rendered ineffective by reason of the unrestricted exportation of the natural resources.[13] With the dissolution of Parliament in the Spring of 1974 this Bill died on the order paper.

In connection with the existing Ontario measures and the proposed federal measures to encourage processing in Canada, the Committee notes that these constitute approaches which do not focus on the ownership of the firm, a factor which may ultimately be unrelated to the degree of processing minerals in Canada. Such an approach permits the policy

flexibility necessary to achieve a fine balance between Canada's interest in promoting resource development on a broad front while at the same time achieving a higher degree of processing.

The screening process established pursuant to the Foreign Investment Review Act is another mechanism which can be used to promote on a selective basis processing in Canada. Indeed the criteria established by the Act in assessing whether a takeover or the establishment of a new business by foreigners is of significant benefit to Canada include the degree of resource processing.[14] The Committee visualizes that the bargaining process with foreigners will promote to some degree Canada's interest in promoting further processing of resources in Canada. Nevertheless, the Committee is concerned that the screen currently applies only to takeovers and the establishment of new operations by foreign controlled firms in unrelated businesses. As there is already a very high proportion of foreign control in the non-renewable natural resources sector and as it is likely that a large proportion of future development in this sector will be undertaken by existing foreign controlled firms, this constitutes a very significant gap in the foreign controlled activity subject to the screen. In a subsequent Report, the Committee will consider the Foreign Investment Review Act in greater detail.

(ii) Canadian Ownership Requirements

Under the Foreign Investment Review Act, the criteria to determine whether a takeover or establishment of a new business in an unrelated field is of significant benefit to Canada include the degree and significance of participation by Canadians in the business.[15]

Federal mining regulations provide that mining leases in the Northwest Territories and the Yukon[16] and mineral exploration grants in Northern Canada[17] can be granted only to Canadians or corporations, a majority of whose shares are held by Canadians or whose shares are listed on a Canadian stock exchange. Parallel restrictions apply to oil and gas leases under federal jurisdiction.[18] However, restrictions on exploratory licences and permits are less demanding and require only that companies be incorporated or licensed in Canada or a province.[19]

On the provincial level there appear to be no Canadian ownership requirements. Under the Mining Act, any individual over eighteen or company incorporated or licensed to carry on business in Ontario may obtain a miner's licence which is necessary to explore for minerals or oil and gas in Ontario and to obtain leases upon discovery.[20] We shall consider in detail below the desirability of mandated ownership requirements.

(iii) Other Policy Techniques

1. Canada Development Corporation

The Canada Development Corporation was established in 1971 with the purpose of, among other things, assisting in the creation and development of resources in Canada.[21]

Since the CDC commenced operations, one of its major undertakings was the acquisition of a controlling interest in Texas Gulf. This represents a major patriation of control of an important resource based enterprise with substantial operations in Canada as well as elsewhere. What effect CDC control will have on the operations of Texas Gulf remains to be seen. At any rate, this CDC move promotes the goal recommended by the Committee of developing a strong and visible Canadian controlled presence in the natural resources sector.

Nevertheless, the Committee is concerned that the CDC become more than simply a vehicle to "buy Canada back." To be sure, selective acquisitions of control positions now held abroad may be in Canada's interest. However, it is the view of the Committee that the activities of organizations such as the CDC should be largely future oriented in the sense of becoming actively involved in large, new and exciting ventures rather than past oriented which a buy-back approach implies. The Committee endorses the view of the purposes of the CDC set forth in the Wahn Committee Report:

> The main purpose of the Canadian Development Corporation should be that of a large holding company with entrepreneurial and management functions; it should assume a leadership role in Canada's business and financial community in close cooperation with existing institutions; it should help to organize a consortium of investors domestic and foreign to carry out large projects beyond the capacity of the single

> institution, while throughout maintaining a clear Canadian presence.
>
> Its main purpose should not be to buy back Canadian businesses now owned by Americans.[22]

The Committee understands that the CDC proposes to make a large distribution of its shares to the public. The Committee also understands that one goal of such a distribution will be to achieve as wide a distribution of the issue as is possible in order to involve as many Canadians as possible.

2. Guidelines

After U.S. President Johnson issued his "voluntary" guidelines, the Canadian Department of Trade and Commerce issued twelve principles of good corporate behaviour for foreign controlled firms in Canada.[23] These guidelines were voluntary and did not have the force of law.

The Gray Report concluded that these guidelines had no significant effect. It has been urged upon the Committee that purely voluntary guidelines are useless because they tend to be far too general to be of any operational usefulness and because they will be ignored in any event. However, it is the view of the Committee that voluntary guidelines can have a usefulness if only to indicate the general direction of public policy and to provide general standards of behaviour against which the actual behaviour of firms can be gauged. Moreover, general guidelines can perform a significant supportive role for specific policy

requirements. At the same time the Committee would caution against relying on voluntary guidelines to perform a substantive role beyond indicating the general direction of public policy and generally supporting specific policy requirements.

3. Ad Hoc Approach

The *ad hoc* approach developed in the context of a growing public concern about the very high and increasing levels of foreign control in major aspects of the Canadian economy, particularly in the natural resources sector. For example, the federal government intervened to prevent the proposed sale of control of Denison Mines and of Home Oil because those sales were not considered to be in the public interest. However, the government chose not to intervene in the sale of Supertest to BP Canada. The *ad hoc* approach resulted in considerable confusion as to the nature of the policy of the federal government with respect to foreign ownership. Why, for example, did the government indicate that it would block the sale of Home Oil to American interests while it chose not to intervene in the sale of Supertest to B.P.? The *ad hoc* approach clearly is not conducive to the development of a coherent policy with respect to foreign investment.

This approach has now been replaced by the establishment of the Foreign Investment Review Agency which will

assess takeovers of firms above the threshold limits and ultimately new investments in unrelated businesses by foreigners according to the criteria set forth in the Act.

4. Direct Government Participation

Another technique which has been used by both provincial and federal governments has been a direct participation in resource ventures. The federal government's participation in Panarctic has been a notable success. However, by and large the experience of provincial governments in this connection has not been satisfactory. It is the view of the Committee that this has been so primarily because provincial governments' involvement in resource firms has been largely directed to rescuing failing ventures in order to save the economies of communities which depend on those ventures. Nevertheless, the Committee is convinced that there is an important role for both the federal and provincial governments in participating directly in resource ventures. The recommendations of the Committee in this respect will be considered below.

5. Thin Capitalization Rules

In the Capital Markets Report, the Committee considered the application of the thin capitalization rules contained in the Income Tax Act.[24] These rules are designed to preclude the artificial deduction of interest on non-arm's length debt of a Canadian subsidiary held by the foreign

parent. In substance, these rules prevent the subsidiary from deducting the interest on debt held by the foreign parent which exceeds three times the equity of the subsidiary. These rules are easily avoided by having the subsidiary raise the funds on the Canadian capital market and utilizing the guarantee of the foreign parent to secure the loan.

The thin capitalization rules are particularly important in the context of ventures in the natural resources industry which are highly capital intensive. Accordingly, the ease with which these rules can be circumvented is of concern to the Committee. Moreover, these rules have the perhaps unintended effect of encouraging foreign controlled subsidiaries of raising debt in Canada, thus pre-empting funds which would otherwise be available in support of Canadian ownership and control and exacerbating the difficulty which Canadian firms have in obtaining financing. The Committee can see no substantive difference between debt of subsidiaries held directly by foreign parents and debt held by Canadian financial institutions guaranteed by the foreign parent. In accordance with a similar recommendation made in the Report on the Capital Markets,

THE COMMITTEE RECOMMENDS THAT CONSIDERATION BE GIVEN TO EXTENDING THE APPLICATION OF THE THIN CAPITALIZATION RULES ALONG THE LINES OF EXCLUDING THE DEDUCTION OF INTEREST ON

THE EXCESSIVE DEBT OF FOREIGN CONTROLLED SUBSIDIARIES WHERE THAT DEBT IS ULTIMATELY GUARANTEED BY THE FOREIGN PARENT.

In the Capital Markets Report, the Committee noted that "normal" debt-equity ratios vary considerably among industries. For example, the normal debt-equity ratio for a resource-based firm is considerably different than for a firm in the light manufacturing industry. In this sense, an extension of the thin capitalization rules in the recommended direction would require a recognition that debt-equity ratios do vary between industries. Therefore, the Committee would suggest that the concept of "excessive debt" contained in the above recommendation be made somewhat flexible to recognize the particular circumstances of various industries. In this connection, the Committee would suggest that the maximum permissible debt-equity ratios for particular industries for the purpose of the thin capitalization rules be established from time to time by regulation. Specifically, the Committee would suggest that the maximum permissible debt-equity ratio established for the natural resources industry recognize the current practice in the industry.

POTENTIAL POLICY TECHNIQUES

IV. POTENTIAL NEW TECHNIQUES

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The application of new policy initiatives or the extension of existing techniques impinging on foreign ownership in the non-renewable natural resources sector might distinguish between new developments, existing operations, and proven reserves under the control of private corporations but not currently exploited. The Committee does not recommend as a general proposition that new policy approaches be applied to existing operations. To do so generally would involve an element of apparent retroactivity which Canada has sought to avoid. Accordingly,

THE COMMITTEE RECOMMENDS AS A GENERAL GUIDE TO THE IMPLEMENTATION OF NEW POLICY INITIATIVES IN THE NATURAL RESOURCES SECTOR THAT THESE INITIATIVES APPLY TO NEW DEVELOPMENTS AND TO PROVEN RESERVES NOT CURRENTLY EXPLOITED BUT NOT TO DEVELOPMENTS CURRENTLY BEING WORKED.

While the Committee is concerned to avoid retroactive application of new policies or the appearance of retroactivity in connection with mines currently being worked, the Committee sees no objection in requiring that the future development of proven reserves which are controlled by firms but not currently being exploited conform to the new policies. Many firms in the natural resources sector have sufficient reserves which are currently not being worked to

to support their operations for many years. Accordingly, the Committee considers it imperative that the new policy initiatives apply to such reserves, otherwise there is little likelihood that those initiatives will have a significant impact in the foreseeable future.

The Committee notes that there are likely to be some difficulties in the implementation of the above recommendation particularly in connection with the definition of what are and what are not new resource ventures. While the details of the definition will need to be developed when the legislation to implement the Committee's recommendations is being drafted and considered, the Committee considers it appropriate to set forth general principles of what it considers to be new resource ventures.

The guiding principle in this connection should be the concept of resources being "worked". Those resources which are not being worked on the effective date of the legislation would be subject to the new rules while those being worked at that time would not. The concept of being worked would involve substantial economic activity with the purpose of exploiting the particular resource. For example, even if a particular ore body has been proven but is not being exploited at the effective date of the legislation, it would be subject to the new rules. Even if, for instance, a mine shaft has been sunk, that venture would not be con-

sidered as being worked if there is no substantial activity with the purpose of extracting the resource. Similarly, a mine which was formerly worked, but which is not worked at the effective date, would be subject to the new rules if that mine is subsequently brought into production again.

A difficulty in terms of the definition of resources currently being worked arises in considering large bodies of proven reserves which are sufficient to support production over a very long period of time. At any given point in time only a relatively small portion of the entire body is being worked. Should the entire body be considered as being worked at the effective date of the new rules? The Committee is of the view that those parts of the resource body currently being exploited should be exempt from the operation of the new rules. However, future developments of other parts of the resource body should be considered new developments for the purpose of applying the proposed new rules.

In connection with the definition of new ventures to which new policy initiatives in the natural resources sector would apply, the Committee notes that under the pre-1972 Income Tax Act, the income from a new mine was exempt for three years following the date on which the mine came into commercial production.[25] This exemption has been discontinued as of December 31, 1973. There has been considerable experience and jurisprudence with regard to the

definition of what constitutes a new mine under these provisions. The Committee anticipates that this experience and jurisprudence would be used in developing and administering the definition of what constitutes a new resource venture for the purposes of applying new rules with respect to foreign ownership and control in the natural resources sector.

(i) Mandated Ownership Requirements

One possible policy technique which is frequently discussed is the implementation of mandatory across-the-board Canadian ownership requirements. This technique would require that all new resource developments be Canadian owned to the extent of a given proportion of the equity. Proportions frequently suggested are 51 per cent or 75 per cent in order to ensure that control ultimately remains in Canada. Indeed, some proponents would apply mandated ownership requirements not only to new resource ventures, but also to existing operations.

A variation of this technique is that exploration permits, licences and leases would be granted only to Canadians or Canadian controlled corporations. It is this technique that is used in connection with the federal mining, oil and gas regulations.[26] It is to be noted, however, that these federal regulations permit corporations to obtain leases and grants even if a majority of their shares

are held abroad as long as their shares are listed on a Canadian stock exchange. The Committee does not consider that the mere requirement to list on a Canadian stock exchange substantively promotes the goals of economic nationalism which the Committee proposes in connection with the non-renewable natural resources sector.

Mandatory ownership requirements are supported on a number of grounds. Firstly, they would promote the goal of developing a strong Canadian controlled presence in the natural resources sector. Secondly, they are relatively simple to administer. Thirdly, they ensure that at least the required proportion of profits, capital gains and other residual benefits of ownership accrue to Canadians. Fourthly, Canadian control may mean increased processing and fabrication in Canada. And fifthly, they are conceptually simple and constitute a visible and apparently decisive response to the high degree of foreign ownership and control in the natural resources sector.

The Committee sees a number of problems with the immediate implementation of mandatory across-the-board ownership requirements in the non-renewable natural resources sector. Firstly, as was pointed out above, the Canadian operations of foreign controlled firms tend to be truncated. From the perspective of Canadian investors, and from the perspective of the Canadian economy as a whole, investment in truncated firms would not appear to be attractive.

Secondly, in connection with the capital markets gap discussed earlier, it is not apparent that Canadian capital markets are presently willing to marshal the large pools of capital required for resource developments, both for individual ventures and in the aggregate. To be sure, to the extent that the capital markets gap is remedied - the Committee has published a separate report on the capital markets - the magnitude of this problem will diminish. Nevertheless, it will take time to enhance the ability and willingness of the capital markets and Canadians generally to meet the demand for Canadian sourced equity capital that across-the-board ownership requirements will generate. It is evident that the higher the proportion of equity mandated to be held by Canadians, the larger will be the problem in terms of the capital markets gap.

Thirdly, mandated ownership requirements ignore what has been referred to above as the marketing gap - the difficulty relative to foreign firms which Canadian firms have in terms of developing assured access to the large foreign markets necessary to render resource ventures economically viable on the world level. Across-the-board requirements may to some extent have the effect of cutting Canada off from the assured access to foreign markets which foreign firms, particularly integrated systems, have.

A fourth problem is that Canadian control will not necessarily lead to more processing in Canada. Canadian controlled firms will be faced with the same

foreign tariff structures which promote unprocessed imports and discourage semiprocessed or processed imports. At any rate, as the Committee has concluded above, a more efficient policy mechanism to achieve more Canadian processing is to promulgate specific processing-in-Canada requirements which apply to all firms.

Fifthly, the protection of Canadian ownership which generalized ownership requirements imply may mean that a Canadian controlled industry which is inefficient by world standards may develop. A balance between a foreign controlled presence and a strong Canadian controlled presence will ensure that the Canadian resources sector will remain a strong and vital one by world standards.

A 51% ownership requirement will not necessarily accomplish the goal of ensuring that control of resource firms remain in Canadian hands. If the shares issued to Canadians are widely held and the remaining shares are concentrated, foreigners may still have effective control of the Canadian firm.

For the above reasons, the Committee has concluded that the problems associated with the immediate implementation of mandated across-the-board Canadian ownership requirements in the natural resources sector outweigh the potential benefits. Nevertheless, in the long-run, the Committee is convinced that the goal of achieving substantial Canadian ownership and control of the non-renewable natural

resources sector is an appropriate one for Ontario and Canada. Accordingly,

THE COMMITTEE RECOMMENDS THAT A LONG-RUN GOAL OF NON-RENEWABLE NATURAL RESOURCES POLICY BE TO ENSURE THAT:

(i) AT LEAST 75 PER CENT OF THE EQUITY OF ALL NEW VENTURES IN THE NON-RENEWABLE NATURAL RESOURCES SECTOR AFTER THE IMPLEMENTATION OF THE COMMITTEE'S RECOMMENDATIONS BE OWNED BY CANADIANS; AND

(ii) NO SINGLE NON-RESIDENT OR RELATED GROUP OF NON-RESIDENTS OWN MORE THAN 10 PER CENT OF THE EQUITY OF VENTURES IN THE NON-RENEWABLE NATURAL RESOURCES SECTOR.

In making this recommendation the Committee recognizes that time will be required for its full implementation in view of the problems considered above with respect to the immediate implementation of mandated Canadian ownership requirements. Time will be required for truncated firms to develop their activities across a broader front in order to become more attractive to Canadian equity markets. Policies designed to remedy the capital markets gap will take time to take hold such that there will be that degree of depth and liquidity required to support the indicated degree of Canadian ownership and control. It will take time for Canadian controlled firms to develop independent access to large foreign markets necessary to render ventures economically attractive. The Committee is of the view that a

a period of 15 years would be ample time for the full implementation of the above recommendation. Once the industry is on notice that it will be required to meet that goal, 15 years is sufficient to arrange its affairs such that it will be in a position to comply with that goal.

In order to achieve an orderly and progressive implementation of this goal and in order to avoid a potentially disruptive bunching of ventures seeking Canadian equity financing at the end of the 15 year period, the Committee would favour that the above recommendation be implemented in stages over the 15 year period.

THE COMMITTEE RECOMMENDS THAT THE RECOMMENDED CANADIAN OWNERSHIP REQUIREMENTS IN THE NON-RENEWABLE NATURAL RESOURCES SECTOR BE IMPLEMENTED IN THREE STAGES OVER A 15 YEAR PERIOD AS FOLLOWS:

(i) AFTER 5 YEARS: AT LEAST 25% OF THE EQUITY OF NON-RENEWABLE NATURAL RESOURCE VENTURES MUST BE HELD BY CANADIANS;

(ii) AFTER 10 YEARS: AT LEAST 50% OF THE EQUITY MUST BE HELD BY CANADIANS;

(iii) AFTER 15 YEARS: AT LEAST 75% OF THE EQUITY MUST BE HELD BY CANADIANS AND NO MORE THAN 10% MAY BE HELD BY ANY ONE NON-RESIDENT OR RELATED GROUP.

The Committee would note that the recommended implementation schedule is a minimum one. It may be appropriate to

accelerate the development of Canadian ownership and control in specific resource ventures. In this connection, the Committee has in mind investments which are subject to the Foreign Investment Review Act where it is appropriate to bargain for more Canadian equity participation at an earlier stage than would be indicated by the recommended schedule.

The Committee would note also that the recommended schedule for the implementation of Canadian ownership requirements is not intended to derogate from other policy techniques designed to promote the development of the non-renewable natural resources sector. Specifically, the Committee visualizes that the technique of selective government participation recommended below could be employed to accelerate the development of Canadian ownership and control of specific ventures if that is considered desirable. However, it should be noted that as the schedule in relation to Canadian ownership requirements progresses, the need to employ other techniques will be reduced accordingly.

The adoption of Canadian ownership requirements as recommended by the Committee does not preclude the employment of foreign sourced capital. Even when the requirements are fully implemented, foreign portfolio investment will have a significant role in the development and growth of the Canadian non-renewable natural resources sector. Up to 25 per cent of the equity may be held abroad and foreign capital in the

form of debt can be freely employed by Canadian controlled ventures. The Committee recommended earlier that foreign portfolio investment should be encouraged and foreign direct investment should be discouraged. The recommended long-term goal of achieving at least 75% Canadian equity ownership of new ventures in the non-renewable natural resources sector is consistent with that recommendation.

The Committee has considered the development of appropriate sanctions to be imposed on firms which fail to comply with Canadian ownership requirements. In addition to the usual penalties such as fines and/or imprisonment, the Committee considers that it is appropriate to restrict the offending firm's growth until the firm complies.

THE COMMITTEE RECOMMENDS THAT SANCTIONS TO BE IMPOSED ON FIRMS IN VIOLATION OF THE CANADIAN OWNERSHIP REQUIREMENTS INCLUDE THE FOLLOWING:

(i) FINES AND/OR IMPRISONMENT TO BE IMPOSED ON SENIOR OFFICERS AND DIRECTORS WHO KNOWINGLY PARTICIPATE IN THE VIOLATION;

(ii) UNTIL THE FIRM COMPLIES, THE RATE OF GROWTH IN BOTH THE GROSS ASSETS AND GROSS REVENUE OF THE FIRM SHOULD BE LIMITED TO 0%.

The purpose of limiting the growth of offending firms is two-fold: Firstly, prohibiting growth is of itself a significant sanction. Secondly, this sanction will

give shareholders an added interest to put pressure on the management of the corporation to ensure that it complies with the ownership requirements. Indeed, failure of the directors to comply with those requirements and thereby subjecting the corporation to limits to its growth may give the shareholders a right of action.

(ii) Selective Government Equity Participation

A variation of across-the-board ownership requirements recommended above would be a requirement that the provincial government be given the opportunity of taking up a certain proportion of the equity in new resource ventures. The indicated maximum proportion would be 50 per cent of the equity. In other words, some new resource developments could become joint ventures between the government and private industry.

The Committee notes that it is not necessarily desirable from the standpoint of promoting the goals of economic nationalism for the government to take equity positions in all resource ventures. If a particular resource venture would be subject to Canadian control without government participation, it may not be necessary for the government to take any equity position. Moreover, from the standpoint of the prudent use of public funds, it does not appear to be desirable for the government to apply public funds to acquire equity positions in every resource

venture without regard to its economic viability. Accordingly, the Committee is of the view that government participation in new resource ventures should take the form of empowering the government on a selective basis to require new resource ventures to offer up to 50 per cent of equity to the government. In deciding whether the government should exercise that power, the government would consider whether government equity participation is in the public interest having regard to, among other things, the extent of Canadian ownership and control of the new venture and its economic viability.

This technique has a number of advantages and would overcome some of the problems associated with the immediate and full implementation of across-the-board ownership requirements. Firstly, this technique would promote the goal of achieving a strong Canadian controlled presence in the resources sector. As the government would hold a large block of the shares in some ventures, the government would be in a position to control that venture if it chooses.

Second, by virtue of its position of control the government's influence on the operations of the firm would presumably be in the public interest. For example, the influence - actual or potential - of government participation would help to ensure that equipment, machinery, engineering services and the like are purchased in Canada, or to achieve a greater degree of processing in Canada.

Third, this technique represents an ostensibly simple formula and would be viewed as a decisive step to remedy the imbalance in terms of foreign participation in the natural resources sector.

Fourthly, government participation would ensure that the profits, capital gains and the other residual benefits of ownership to the extent of the government's participation remain in Canada.

Fifth, direct participation in this way will enable the government to develop a greater understanding of the natural resources sector and gain an inside feel for the industry. Such an understanding is invaluable in developing appropriate resources policies.

A sixth advantage of this technique is that it recognizes the existence of the capital market gap in connection with the financing of Canadian controlled resource ventures. The funds for government equity participation would come from the provincial treasury rather than from the normal capital markets. In this connection, this technique could be regarded as a temporary measure to support Canadian ownership and control until the gaps and deficiencies in the capital markets are remedied and the ownership requirements recommended above are fully implemented. In addition, government participation along these lines would to some extent remedy the marketing gap. This technique would lend the weight of the provincial government to the new venture in terms of developing secure foreign markets for output.

A further advantage of this technique is that government need not take up the maximum 50% equity percentage of a resource venture in which the government chooses to take up a position. The government can take a lesser equity position. For example, if a resource venture plans a public distribution of equity in Canada, it may be appropriate for the government to take a much smaller equity position, or indeed, none at all.

In its commissioned studies, the Committee found that firms in the resources sector would accept - indeed, they would welcome - government participation along these lines, provided that the government would put up its share of exploration and development expenses and accepted its share of the risks.

In its discussions with officials of the U.K. Government in connection with that government's 50 per cent interest in British Petroleum, the Committee was encouraged and persuaded that government equity participation in the resources sector worked well.

While there are important benefits to be achieved by this technique, there are some problems associated with it. First, some would argue that it is not appropriate for government to risk the funds of taxpayers to the indicated extent and that it is not appropriate for government to become involved in the private sector to such a great degree.

The Committee understands this argument and accepts it as being the major negative factor involved in the adoption of this technique. Nevertheless, this technique can be used as a temporary measure designed to meet the gaps and problems which currently militate against Canadian controlled participation in the natural resources sector. This technique of requiring government participation could be gradually phased out as the policy initiatives designed to remedy the capital market gap, the marketing gap and the other factors which inhibit Canadians' ability to participate in a major way begin to take hold and as the ownership requirements recommended above are implemented. Moreover, while this technique of the government selectively acquiring equity positions is employed, the government could divest itself from time to time of shares in ventures which have matured to the point that the issue would be attractive to the Canadian capital markets. In this way the treasury could potentially recoup on an ongoing basis its initial investments and in addition the capital gains accruing during the period in which the shares were held by the government. It would be necessary, of course, that secondary issues of this sort be constrained shares such that they could not be sold to non-residents.

The Committee regards this technique as largely a temporary measure to be used selectively by the government as a supplementary technique to the Canadian ownership requirements recommended above. In the early stages of the

implementation schedule for Canadian ownership requirements, the government equity participation technique would be used sparingly in situations involving resource ventures where it is particularly desirable to inject a substantial degree of Canadian ownership in excess of that that would be required under the implementation schedule for the Canadian ownership requirements, but where it is evident that the desired degree of Canadian ownership is not forthcoming without government participation. Moreover, the selective government equity participation technique could be used as a measure to smooth some of the problems that may develop in the implementation of the Canadian ownership requirements.

Second, the large potential outlays of government funds for exploration and development and for acquisition of the equity position in ventures might have a significant impact on the treasury.

A third problem associated with this technique involves the administration of this technique. How, for example, are the day-to-day decisions to be made? What will be the government's position with respect to the corporate decision-making process? Will purely political considerations affect the operations of the corporation? Problems of this kind arise in any government venture in the private sector. The Committee visualizes that the government will regard equity positions in corporations in

which it chooses to take equity in the same way as any intelligent shareholder would. The government would vote its share in such a way to ensure that management conducts the affairs of the corporation in a businesslike manner and in accordance with stated government policy.

A danger involved in adopting this technique of government equity participation in selected resource ventures is that pressures may develop such that the government is regarded as a source of finance for economically questionable ventures. The Committee is concerned to avoid these kinds of pressures while at the same time maintaining a degree of flexibility to permit the government on its own initiative to step in where appropriate.

In the Report of the Capital Markets published by the Committee, the Committee recommended an expanded role for Ontario's Development Corporations including the acquisition of firms in selected industries. One aspect of this expanded role envisioned by the Committee would involve the administration of this selective government participation technique. A resource venture seeking government equity participation would be required to apply to one of Ontario's Development Corporations. As a condition of granting the equity financing, it could be required that the applicant

demonstrate, among other things, that the required financing is not available from other Canadian sources, that the proposed venture is economically viable, that the proceeds of the financing will be employed in the development of the resource and that government equity participation is otherwise in the public interest. Requirements along these lines will ensure that requests for government equity participation initiated by the industry are of a substantive nature and will minimize requests from questionable ventures. In this connection, the Committee visualizes that this policy technique of selective government equity participation will be administered in a manner that is not significantly different from the way in which the loan programmes are currently being administered by Ontario's Development Corporations. At the same time, however, there would be a maximum flexibility for the government itself to initiate requests for an equity position in situations where that is considered to be in the public interest.

To implement this technique of selective government equity participation it will be necessary to develop a notification procedure whereby the government is notified that a proposed venture in the non-renewable natural resources sector is at the stage of developing the resource with a view to exploitation. After the government is so notified, there should be a time limit for the government to indicate if it wishes to take any of the equity in the new venture.

THE COMMITTEE RECOMMENDS THAT:

(i) NEW VENTURES IN THE NON-RENEWABLE NATURAL RESOURCES SECTOR SHOULD BE REQUIRED TO FILE WITH THE GOVERNMENT OF ONTARIO NOTICE OF PROPOSED OPERATIONS;

* (ii) THE GOVERNMENT SHOULD BE EMPOWERED TO TAKE UP TO 50% OF THE EQUITY IN NEW VENTURES IN THE NON-RENEWABLE NATURAL RESOURCES SECTOR;

(iii) THE GOVERNMENT SHOULD BE REQUIRED TO NOTIFY THE NEW VENTURE WHETHER AND TO WHAT EXTENT IT WISHES TO TAKE UP EQUITY WITHIN 15 DAYS AFTER FILING OF THE NOTICE. AFTER THE EXPIRATION OF 15 DAYS THE GOVERNMENT WOULD BE DEEMED TO HAVE ELECTED NOT TO TAKE UP ANY EQUITY.

REQUESTS FOR GOVERNMENT EQUITY PARTICIPATION INITIATED BY FIRMS IN THE NATURAL RESOURCES SECTOR SHOULD BE SCREENED BY ONTARIO'S DEVELOPMENT CORPORATIONS AND SHOULD BE ACTED ON ONLY IF

(i) THE PROPOSED VENTURE IS ECONOMICALLY VIABLE;

(ii) THE PROCEEDS OF GOVERNMENT EQUITY FINANCING WILL BE USED IN THE DEVELOPMENT OF THE RESOURCE;

* Messrs. Kennedy and Walker dissent from this recommendation. See p. 87.

(iii) THE REQUIRED FINANCING IS NOT AVAILABLE FROM OTHER CANADIAN SOURCES;

(iv) CONTROL OF THE PROPOSED VENTURE WILL CONTINUE TO BE IN THE HANDS OF CANADIANS; AND

(v) GOVERNMENT EQUITY PARTICIPATION IS OTHERWISE IN THE PUBLIC INTEREST.

In conjunction with the implementation of this recommendation, when the government chooses to take an equity position it is necessary that the valuation of the shares to be transferred to the government include the government's share of the risks and costs, such as exploration and development expenses, in developing the venture. This will in substance involve a bargaining process between the government and the firm which proposes to develop the venture.

THE COMMITTEE RECOMMENDS THAT AS VENTURES IN WHICH IT HAS AN EQUITY INTEREST MATURE TO THE POINT THAT A SECONDARY ISSUE TO THE PUBLIC IS FEASIBLE, THE GOVERNMENT SHOULD BE EMPOWERED TO OFFER ITS SHARES TO THE PUBLIC AT AN APPROPRIATE PRICE. THE SHARES ISSUED TO THE PUBLIC SHOULD BE CONSTRAINED SHARES IN THAT THEY CANNOT BE SOLD TO NON-RESIDENTS.

This recommendation can have the effect over the longer run of minimizing the impact of the technique on provincial revenues and of returning equity in mature resource ventures to the private sector.

The Committee visualizes that the policy techniques recommended above, namely requiring Canadian ownership in resource ventures to be implemented in stages and requiring selected ventures to offer equity positions to the government, will be combined in an approximate mix of policy techniques designed to achieve a viable Canadian controlled presence in the non-renewable natural resources sector. The selective government equity participation technique would be applied to ventures which have the potential of being attractive to Canadian capital markets but are not yet ready to go to the public or to ventures where government equity involvement is considered important for the venture to develop along certain lines, such as achieving a given degree of processing and manufacturing in Canada, ensuring use of Canadian inputs (e.g. engineering and technical services) developing secure inputs (e.g. uranium, lignite) for other government activities such as Ontario Hydro or promoting environmental and conservation goals.

(iii) Royalty Payments In Shares

Another technique which commends itself to the Committee in terms of developing an appropriate mix of policy is

for the government to collect royalty payments in the form of shares in the corporation rather than in cash. The technique of collecting taxes in the form of shares rather than cash is already employed under The Succession Duty Act whereby the person required to pay succession duty in respect of a family business can elect to pay that duty in the form of shares in the business.[27] This technique in the context of the natural resources sector would be mandatory rather than elective.

The number of shares to be transferred to the Treasurer would be such that the fair market value of the shares is the same as the amount of cash royalty payments that would otherwise be exigible. In terms of the kind and class of shares transferable to the Treasurer, the same approach as that in The Succession Duty Act could be used: the shares would have to be "of a class and quantity acceptable to the Treasurer in the corporation that have a fair market value at the time of such transfer of not less than the (royalty) owing" by the corporation.[28] There may be problems in terms of determining fair market value, especially in relation to corporations which are not publicly traded. However, problems in this connection are not insurmountable. In the final analysis these would be resolved through negotiations between the corporation and the Treasurer.

The Committee visualizes that this technique would be applied to all new ventures in the non-renewable natural resources sector whether foreign or Canadian controlled on a non-discriminatory basis. It would lend itself easily to being applied to existing resource ventures as well as new ventures, or to foreign controlled ventures only, if that is considered desirable. The Committee does not recommend that this requirement be applied to existing ventures or exclusively to foreign controlled firms. Or this technique could be applied selectively to firms in situations where the Treasurer or the Minister of Natural Resources deems it to be in the public interest.

This technique could be combined with cash royalty payments: part of the royalty could be required to be paid in the form of shares and the other part in cash. For example, it could be required that at least half of the royalty be paid in shares and the corporation could be given the election to pay all or part of the remaining half in shares and the rest in cash.

There should be a maximum proportion of the equity held by the government. The Committee suggests that no

corporation should be required to issue shares pursuant to this requirement if the issue of such shares would give the government more than 50 per cent of the voting rights attached to shares. If the threshold of 50% would be exceeded, cash payments would be required. It may be desirable to provide for a sliding scale in respect of the proportion of the royalty payments required to be made in shares. For example, if the shares held by the government represent less than say 20% of the outstanding shares, all of the royalty payments would have to be made in the form of shares; a government shareholding of between 20% and 30% would require that 75 per cent of the payment would have to be made in shares and so on.

The Treasurer should be empowered to sell the shares acquired pursuant to this technique on the public markets when he considers it to be in the public interest. If shares are publicly traded, he should be empowered to sell shares on the public markets. If shares are not publicly traded, then the Treasurer should be empowered to make a public offering of the shares held by him. The expense of the public issue should be borne by the Treasurer; in this connection, there should be a requirement that the corporation co-operate in satisfying securities law requirements. In addition, there would have to be safeguards to ensure that not more than 50 per cent of the outstanding shares of the corporation from time to time have been filtered through the treasury pursuant to this technique.

This technique permits the government over time to accumulate substantial equity positions in new ventures in the non-renewable natural resources sector. This promotes the goal of achieving a greater degree of Canadian ownership and control in this sector. Moreover, government shareholdings would give the government an inside track into the affairs of resource companies and would provide the government with an opportunity to develop a greater understanding and feel for the industry generally.

The power of the Treasurer to spin off government shareholdings to the public would permit Canadians to participate in this industry to a greater degree than currently. The depth and liquidity of the equities market would be enhanced. In addition, the revenue would to some extent be protected.

This technique is in essence a self-liquidating method to inject more Canadian ownership into the resources sector. Moreover, the technique will result in more cash being available to corporations to the extent that cash royalty payments are replaced with payments in shares.

Government shareholdings accumulated pursuant to this technique mean that the returns to the public from the natural resources sector involve not only royalty payments and income taxes but also the capital gains and dividend payments attributable to those shareholdings.

In view of the foregoing,

THE COMMITTEE RECOMMENDS THAT CONSIDERATION BE GIVEN TO EMPOWERING THE TREASURER TO COLLECT ROYALTY PAYMENTS IN RESPECT OF NEW RESOURCE DEVELOPMENTS IN THE FORM OF SHARES. THE ESSENTIAL FEATURES OF THE RECOMMENDED SYSTEM WOULD BE AS FOLLOWS:

1. THE FAIR MARKET VALUE OF THE SHARES TRANSFERRED TO THE TREASURER SHOULD BE EQUAL TO THE AMOUNT OF CASH ROYALTIES THAT WOULD OTHERWISE BE EXIGIBLE; THE CLASS AND QUANTITY OF SHARES ISSUED SHOULD BE ACCEPTABLE TO THE TREASURER.

2. THE SYSTEM SHOULD APPLY TO BOTH CANADIAN AND FOREIGN CONTROLLED FIRMS.

3. THE MAXIMUM PROPORTION OF THE OUT-STANDING VOTING SHARES ISSUED TO THE TREASURER SHOULD NOT EXCEED 50 PER CENT AT ANY TIME. ONCE THE 50 PER CENT THRESHOLD IS REACHED, ROYALTY PAYMENTS WILL BE MADE IN CASH. IF THE CORPORATION THEREAFTER ISSUES FURTHER SHARES, THE CORPORATION COULD AGAIN BE REQUIRED TO PAY ROYALTIES IN SHARES UNTIL THE 50 PER CENT LIMIT IS REACHED ONCE MORE.

4. THE TREASURER SHOULD BE EMPOWERED TO SELL SHARES ON THE PUBLIC MARKETS. HOWEVER, THE SALE OF SHARES BY THE TREASURER

SHOULD NOT OPERATE SO AS TO REQUIRE THE COMPANY TO ISSUE MORE SHARES TO THE TREASURER; IN NO SITUATION SHOULD THE TOTAL NUMBER OF SHARES ISSUED TO (BUT NOT NECESSARILY HELD BY) THE TREASURER EXCEED 50% OF THE OUTSTANDING SHARES AT ANY GIVEN POINT IN TIME.

The Committee notes that this system could be combined with the government participation technique recommended above. For example, it could be required that the government be given the opportunity of taking up 25 per cent of the equity in new resource ventures. In addition, royalties would be required to be paid in the form of shares up to an additional 25 per cent of the equity of the corporation. The Committee is of the view that the extent of government participation through the combined operation of any policy techniques requiring issue of shares to the government should never exceed 50 per cent.

(iv) Mining Machinery and Engineering Consulting Services

In connection with the commissioned studies of the mining and engineering consulting industries, the Committee noted that there were few Canadian owned corporations supplying machinery and equipment to the mining

industry. Moreover, the Committee noted foreign controlled corporations in the mining sector have a tendancy to use foreign controlled engineering consulting firms, particularly in the initial stages of foreign controlled resource developments. However, the Committee's commissioned studies indicated that both Canadian and foreign controlled corporations purchase machinery and equipment produced in Canada to a certain extent and that as foreign controlled mining ventures mature their purchases of engineering consulting services from Canadian controlled firms do not differ significantly from those of Canadian controlled resource firms.

The Committee also found that the foreign controlled mining machinery and equipment firms are significantly truncated in the sense that many of them do not perform research and development in Canada and that some are precluded from exporting to certain markets by their parents.

Accordingly, the Committee has concluded that policy initiatives on two broad fronts are required. First, in view of the fact that the Canadian mining sector is large by world standards, the Committee believes that there is scope for the development of a significant Canadian controlled presence in the mining machinery and equipment industry. In the Report on the Capital Markets the Committee recommended that consideration be given to

providing concessional financing for the machinery, equipment and engineering services industry. In addition,

THE COMMITTEE RECOMMENDS THAT THE GOVERNMENT ACTIVELY ENCOURAGE THE DEVELOPMENT OF CANADIAN CONTROLLED FIRMS IN THE MINING MACHINERY AND EQUIPMENT INDUSTRY THROUGH THE PROVISION OF LOANS AND RESEARCH ASSISTANCE AND THROUGH PURCHASING POLICIES.

In this connection, the Committee visualizes that the equity positions in resource ventures accumulated by the government in resource ventures by means of the earlier recommendations with respect to government participation and the collection of royalties in the form of shares could be used to ensure that those ventures purchase machinery and equipment from Canadian firms to the extent practicable. The Committee is of the view that if the private sector does not respond to policies designed to encourage the development of the mining machinery and equipment industry, it may be appropriate for the government to become involved in this area directly.

The second policy initiative would involve the improvement of the performance of mining machinery and equipment firms, whether Canadian or foreign controlled.

THE COMMITTEE RECOMMENDS THAT POLICIES BE DEVELOPED TO IMPROVE THE PERFORMANCE OF MINING MACHINERY AND EQUIPMENT FIRMS IN TERMS OF EXPORTS, RESEARCH AND DEVELOPMENT AND INCREASING CANADIAN VALUE ADDED.

The screening process established federally can play a role in this connection in terms of bargaining with foreign investors seeking to establish new firms. An expanded screening process to encompass expansions in related businesses would permit bargaining in the indicated direction with established firms in the industry.

Finally, in order to counter the tendency of foreign firms to use the services of foreign consulting engineering firms in the initial stages of new resource ventures, the Committee suggests that the screening process encourage the use of the consulting and engineering services in the early stages of new resource ventures.

DISSENTING OPINIONS AND ADDITIONAL COMMENTS

COMMENT OF MESSRS. DEANS, MARTEL AND SMITH CONCERNING RECOMMENDATION ON PAGE (i), NO. 3 AND ON PAGE 13:

Messrs. Deans, Martel and Smith concur in the recommendations concerning the achievement of a strong and visible Canadian controlled presence in the non-renewable natural resources sector. However, considering the unique and important role that natural resources will play in Ontario's future, future development of resources in Ontario should be undertaken with direct government participation.

DISSENTING OPINION OF MESSRS. KENNEDY AND WALKER FROM RECOMMENDATION ON PAGE (iv), NO. 20 AND ON PAGE 74:

This recommendation permits the government, at its option, to acquire up to 50% equity in mining enterprises. This ignores the fact that the private sector may have invested heavily in exploration, and be at the stage of developing an economically viable operation.

This is grossly unfair to the private sector, and would in effect be a move toward nationalization in part of the non-renewable resource industries. It will discourage exploration by private firms.

There is no evidence to support the need for government to intrude into the industry in this manner. Exploration companies with appropriate incentives and encouragement are quite capable of finding and developing new deposits.

Public interest and sharing in the exploitation of these resources can continue to take the form of provision of aid and incentives by government and appropriate taxation.

There is now declining activity and investment in exploration. To stabilize or reverse this the government should be empowered to enter into joint ventures, make loans or take equity by mutual agreement with industry. This participation could be through the Ontario

Development Corporation or a new Crown Agency.

The government's mineral exploration assistance programs should be expanded.

APPENDIX

INCOME TAXATION OF THE NATURAL RESOURCE SECTOR

C O N T E N T S

APPENDIX

INCOME TAXATION OF THE NATURAL RESOURCE SECTOR

FEDERAL INCOME TAX ACT

Under the Federal Income Tax Act, there are six major features of the income taxation of the natural resource industry.

1. Canadian Exploration and Development Expense

(a) "Principal business corporations" can fully deduct their exploration and development expenses (Can. E & D) from income from any source. This deduction was also available under the old Income Tax Act, except that now the definition of Can E & D has been expanded to include the acquisition cost of resource properties. The proceeds of sale of resource properties however is fully included in income. Generally, all expenses incurred in the preproduction period which do not give rise to permanent buildings or machinery can be treated as E & D expense. Thus, all preproduction expenses can be recouped before any federal tax is paid on mining income.

(b) Non-principal business corporations can now deduct 20% of their Canadian Exploration & Development expense against all income, or such greater amount that is equal to their resource income. Previously, non principal business corporations could not generally deduct exploration and development expense from non-resource income.

2. Foreign Exploration and Development Expense

All taxpayers can deduct the greater of 10% of foreign exploration and development expense incurred or an amount in respect of foreign E & D expense equal to foreign resource income earned. In this regard, it might be noted that if the foreign exploration and development expense is incurred by a subsidiary company incorporated in the foreign jurisdiction, the Canadian parent would be unable to deduct the expenses from its own income for Canadian tax purposes.

3. Fast Write-Offs

Accelerated capital cost write-offs are available with respect to most mine buildings and equipment that are acquired after November 7, 1969 and before a mine comes into production in reasonable commercial quantities, or for the major expansion of an existing mine. The cost of such assets can be written off immediately to the full extent of the income from the new mine, thus ensuring that the full cost of a new mine can be written off before any federal income tax is paid. In addition, if insufficient income is generated from one new mine to allow for deductibility of 30% of the cost of these assets, an additional amount up to 30% of the undepreciated capital cost of these mining assets can be deducted from income of other new mines owned by the taxpayer. The fast write-off provisions covers social overhead capital involved in establishing the mining community

such as airports and other transportation facilities, fire halls, hospitals, power lines, schools, sewage and water systems and town halls.

Previously, the Federal Income Tax Act allowed a three year tax holiday for new mines. The Federal Government has substituted the fast write-off provisions above for the three year tax holiday.

4. Depletion Allowances

The pre-reform provisions relating to depletion allowances for natural resource operators continues under the Federal Act until the end of 1976. This depletion allowance is equal to 33-1/3% of the operators production profits for the year.

After 1976, however, the depletion allowance has to be "earned" by the taxpayer spending sums on the following:

(a) assets acquired for new mines or major expansions of existing mines (not including expenditures on social overhead capital);

(b) assets for processing minerals in Canada to the prime metal stage;

(c) assets used to process minerals in Canada beyond the stage to which the particular minerals had been processed previously in Canada;

(d) Canadian Exploration & Development expense, but not including the cost of resource properties.

After 1976, a taxpayer will be permitted a deduction of $1 for every $3 spent on the above assets or activities, up to a maximum of 33-1/3% of his resource profits for the year as defined.

Depletion allowance for shareholders in respect of dividends received from natural resource companies is no longer available under the Federal Act.

5. Credits for Provincial Taxes

(a) All corporations continue to be allowed a provincial tax credit equal to 10% of taxable income.

Ontario corporate tax is 12% of taxable income so that this credit does not relieve corporations from the total burden of provincial corporate tax.

The Ontario corporate tax applies to all corporations, including those involved in the natural resource sector.

(b) At present, the federal Act provides a deduction from income for provincial mining taxes, in the same fashion as that allowed under the former Act. Generally, this deduction is equal to the lesser of provincial mining taxes paid or that proportion of the mining taxes paid that mining income computed under federal rules was of mining income computed under provincial rules.

Ontario's Mining Tax Act, 1972 has imposed a 15% tax on Ontario mining profits. The recent Ontario Budget announced that this rate of tax will be amended as discussed below.

The present federal deduction for provincial mining taxes paid will not apply after 1976. Instead, a corporation will be allowed a further tax credit generally equal to 15% of taxable mining production profits earned in a province. Federal tax payable on mining profits earned after 1976 will therefore be subject to Federal tax at the rate of 21% (46% less 10% corporation tax credit and less 15% provincial mining tax credit).

6. International

The Federal Income Tax Act does not differentiate between resident and non-resident taxpayers in the application of the foregoing provisions to the natural resource industry in Canada. In the international context there is, of course, the withholding tax on dividends and other payments such as royalties made to non-residents as well as the tax on Canadian branch profits of a foreign corporation, but these apply generally to all non-residents regardless of the type of activity involved.

The rate of withholding tax is presently 15%, but will be increased to 25% after 1975 on payments made to non-residents of jurisdictions with which Canada has not then entered into a tax treaty providing for a lower rate. The

branch tax is also to be increased from 15% to 25% after 1975, in accordance with the intent that the purpose of the branch tax is to more or less equalize the position of a branch in Canada with that of an operating subsidiary. A corporation whose principal business is iron ore in Canada is specifically exempted from the branch tax.

Since the natural resource industry is capital intensive, it is also worth mentioning the "thin capitalization" rules now found in the Federal Income Tax Act. Under these rules a portion of the interest paid by a corporation on debts payable to non-residents may be disallowed in the computation of income. The amount of the disallowance is generally, the proportion of the interest paid on non-resident shareholder debt that the amount of such debt less three times the shareholder's equity of the corporation is of the total of the non-resident shareholder's debt. Put another way, wherever the ratio of non-resident shareholder debt to equity is greater than three to one, interest deductibility will be limited.

1974 FEDERAL SPRING BUDGET PROPOSALS

A number of amendments to the Income Tax Act were proposed in the Federal Budget introduced in Parliament on May 6, 1974, including important changes in the area of natural resource taxation. The Minister of Finance, in commenting on the tax changes recommended for the mining and petroleum industry cited the large price increases of oil in

recent months, and the major price increases in mining that have resulted from shortages and inflationary expectations. He therefore felt it necessary to strike a new balance appropriate to these changed circumstances. Although the budget resolutions have not been implemented because of the Government's defeat on the budget, it is worthwhile to highlight the proposed amendments some of which may be re-introduced by the new government.

(1) It was proposed that the basic rate of corporation tax applicable to production profits from minerals, oil and gas be increased to 50% and remain at that level. The general corporate tax rate prevailing now for the 1974 tax year is 48%, reducing to 46% in 1976.

(2) It was proposed that mining taxes, royalties and other amounts which are payable to government bodies no longer be deductible in computing the income of the operator of the resource.

Instead, an extra abatement from federal income tax in respect of taxable production income would take effect immediately, rather than in 1976 as mentioned above. The extra abatement would be 15% in the case of mineral profits (the same rate of abatement that would have applied after 1976 under the present Act) but only 10% in the case of petroleum profits.

The 15% abatement that would take effect after 1976 was intended to replace any deduction for provincial

mining taxes; however, the new proposal would mean that not only provincial mining taxes but also provincial royalties and other provincial revenues derived from the natural resource companies would cease to be deductible federally.

The Minister of Finance, in making this proposal, stated that recent provincial tax policies in relation to mining and oil, particularly the rise of royalties to increase provincial revenues, have made it impossible to arrive at a meaningful distinction between mining taxes and the varying types of royalties and arrangements.

The Budget proposals would mean a net federal tax rate of 30% on Canadian petroleum profits and 25% on Canadian mineral profits, given the existing provincial corporate tax abatement of 10% and the proposed additional abatement.

(3) The Minister of Finance also stated in his comments on the Budget that it is apparent that the petroleum and mineral resource industries in Canada have reached sufficient maturity that the existing tax incentives are more generous than is needed to encourage existing development. Accordingly, proposals were included to cut back on the existing incentives as follows:

(a) Depletion allowance can be claimed only if earned to an annual maximum of 25% of production income rather

than the existing rate of 33-1/3%;

(b) Canadian exploration and development expenditures incurred in the future, would no longer be fully deductible immediately, but must be amortized at a rate of 30% calculated on the diminishing balance basis.

The following chart, extracted from the Budget contains a capsule summary of the tax situation applicable to the mining and petroleum sector.

Item	Pre-Reform	Tax Reform	Budget Proposals
Tax rates	Basic rate of 50% on production profits of mining and petroleum corporations, subject to 10% provincial abatement applicable to all corporations.	As for other corporations, basic rate goes down one point annually after 1972 to 46% in 1976. Tax abated additional 15% after 1976 for mining production profits, with cancellation of deduction for provincial mining taxes.	Basic corporate rate of 50% established for both mining and petroleum production profits, subject to new resource-profit abatement in addition to normal provincial abatement. Net federal tax rate thereby reduced to 30% for petroleum production and 25% for mining production.
Provincial mining, royalties and other similar arrangements	Deductible by mining and petroleum corporations.	Royalties and rentals generally deductible. Provincial mining taxes or income-related royalties not deductible by mining corporations after 1976.	No longer deductible by either mining or petroleum corporations in computing taxable income.
Operator's depletion	Automatic depletion allowances permit reduction of production profits by 33-1/3%.	Automatic depletion continues to end of 1976. Thereafter, depletion "earned" by eligible expenditures on exploration and development and certain capital expenditures, deductible at maximum rate of 33-1/3% of production profits. $3 of eligible expenditures earn $1 of depletion.	Earned depletion system to commence immediately. Rate of claiming reduced to 25% of production profits from 33-1/3%. $3 of eligible expenditures earn $1 of depletion.
Non-operators' depletion	Depletion allowance of 25%	Rate of 25% continues to end of 1976. Thereafter, such rentals and royalties treated as production income eligible for 33-1/3% earned depletion.	Continues to be eligible for earned depletion, but rate of claiming reduced to 25% from 33-1/3%.

Item	Pre-Reform	Tax Reform	Budget Proposals
Canadian exploration and development expenses			
Principal-business taxpayers	Deductible to extent of income in year or any subsequent year.	No change.	Expenditures incurred after budget day deductible at rate of 30% of unclaimed balance.
Non-principal-business taxpayers	Deductible only from mining and petroleum income.	Deductible from income from resource or 20% of unclaimed balance, whichever greater.	Expenditures incurred after budget day deductible at rate of 30% of unclaimed balance.

ONTARIO TAXATION OF MINING INDUSTRY

The Ontario Mining Tax Act, 1972, taxes mining profits in excess of $50,000 at a flat rate of 15%. The 1974 Ontario Budget contains proposals to increase significantly this rate of tax, mainly on the ground that the recent surge in world demand has resulted in sharply higher metal prices and substantial windfall gains for the mining industry in Ontario. The Government has therefore proposed an increase in mining taxes aimed at doubling the Ontario revenue from the tax and at sharing in this windfall gain. The present 15% tax will be replaced with a graduated tax ranging from 15% on profits between $100,000 to $1 million, to 40% on profits over $40 million.

In computing mining profit under the Mining Tax Act, in addition to normal expenses related to the operation of a mine, a deduction is allowed equal to at least 15% of the expenditure incurred for actual exploration and development done in Ontario with the object of finding, testing or opening up deposits of mineral substances. In addition, there is an allowance for the cost of development of a mine of 10% per annum of the capitalized cost of development, provided that, inter alia, the ore taken from the mine is beneficiated at least to the smelter stage in Canada.

In addition to the increase in rates under the Mining Tax Act, the Ontario Government has proposed in the 1974 Budget measures to increase revenues from the mining

industry, including the abolition of the three year exemption for new mines. At the same time, new incentives are proposed to increase the incentive for exploration and processing in Ontario, including the introduction of the federal fast write-off provisions for Ontario income tax purposes, and the ability for non-principal business corporations to fully deduct exploration and development expenses incurred in Ontario. In addition, the Budget proposals include full deduction of pre-production expenses under the Mining Tax Act. These are now allowed only to a limited extent.

With respect to timber resources, the 1974 Budget proposals include doubling Crown dues from cutting of timber on Crown lands as a first step in the implementation of a new system to be developed for this sector.

We have not surveyed in this section the various payments for licenses or leases required under The Mining Act of Ontario. These are relatively minimal from a revenue point of view.

F O O T N O T E S

FOOTNOTES

1. Corporations and Labour Unions Returns Act, Report for 1970, Part I, Statistics Canada, p. 16.

2. Foreign Direct Investment In Canada, Information Canada, 1972, (Gray Report), pp. 45-47.

3. Ibid., p. 48.

4. Eric N. Kierans, "Towards a New National Policy", The Canadian Forum, January-February 1972, p. 54. The figures are estimates to be sure; but they do serve to highlight the issue involved in this discussion.

5. Gray Report, pp. 47-49.

6. Ontario, Select Committee on Economic and Cultural Nationalism, Capital Markets, Foreign Ownership and Economic Development, Interim Report, 1974.

7. Supra., p. 7-8.

8. See Vernon, Raymond, Sovereignty at Bay, 1971, p. 137. Vernon makes the point that the oligopolistic strategy is to concentrate profits at the stage in the system most inaccessible to competitors or to discourage competitors from entering the business at the point of easiest entry by keeping those activities unprofitable.

9. Royal Commission on Canada's Economic Prospects (Gordon Commission), Final Report, 1957, Information Canada, pp. 227-229.

10. Mining Act, R.S.O. 1970, c. 274, s. 113. The degree of processing required by the legislation is that ores must be treated and refined in Canada so as to yield refined metal suitable for direct use in the arts without further treatment. Subsection 133(2) gives the Minister power to determine the stage of refinement which meets that test.

11. Mining Tax Act, 1972, S.O. 1972, c. 140, s. 3(3)(n).

12. Mining Tax Act, R.S.O. 1970, c. 275, s. 3(4).

13. Bill C-4, 2nd Session, 29th Parliament, 1974, s. 1. Note that the Gordon Commission made a similar recommendation, see footnote 9, pp. 228-229.

14. Foreign Investment Review Act, S.C. 1973, c. 46, s. 2(2)(a).

15. Ibid., s. 2(2)(b).

16. Canada Mining Regulations, SOR/61-86, SOR/62-249, SOR/66-80.

17. Northern Mineral Exploration Assistance Regulations, SOR/66-404, SOR-584.

18. Canada Oil and Gas Regulations, SOR/61-253, s. 55.

19. Ibid. These regulations relate to lands in the Yukon and the Northwest Territories and other lands under federal jurisdiction. See Territorial Lands Act, R.S.C. 1970, c. T-6 and Public Land Grants Act, R.S.C. 1970, c. P-29.

20. Mining Act, R.S.O. 1970, c. 274, ss. 25, 35, 121.

21. Canada Development Corporation Act, S.C. 1970-71-72, c. 49, s. 6(1)(a), (b).

22. Eleventh Report of the Standing Committee on External Affairs and National Defence Respecting Canada - U.S. Relations, Second Session, 28th Parliament, September 1970 (Wahn Report), p. 134.

23. A text of the guidelines and the accompanying letter by Mr. Winters appears in Wahn Report, p. 80.

24. Income Tax Act, S.C. 1970-71-72, c. 63 as amended, s. 18(4).

25. Income Tax Act, R.S.C. 1952, c. 148, as amended to July, 1971, s. 83, and Income Tax Regulations, Part XIX.

26. See supra., p. 48.

27. Succession Duty Act, R.S.O. 1970, c. 449, as amended, s. 176.

28. Ibid., S. 176(2)(b).